No. 89-530-CFX
Status: GRANTED

Title: Portland Golf Club, Petitioner
v.
Commissioner of Internal Revenue

Docketed:
September 28, 1989

Court: United States Court of Appeals
for the Ninth Circuit

Counsel for petitioner: Henzke, Leonard J.

Counsel for respondent: Solicitor General

Entry	Date	Note	Proceedings and Orders
1	Aug 18 1989	G	Application (A89-158) to extend the time to file a petition for a writ of certiorari from August 30, 1989 to September 29, 1989, submitted to Justice O'Connor.
2	Aug 28 1989		Application (A89-158) granted by Justice O'Connor extending the time to file until September 29, 1989.
3	Sep 28 1989	G	Petition for writ of certiorari filed.
5	Oct 27 1989		Order extending time to file brief of respondent on the merits until November 29, 1989.
6	Nov 28 1989		Order further extending time to file brief of respondent on the merits until December 28, 1989.
7	Dec 20 1989		Brief of respondent CIR filed.
8	Dec 20 1989		DISTRIBUTED. January 12, 1990
9	Jan 16 1990		Petition GRANTED.
			**********
10	Feb 14 1990		Record filed.
		*	Certified copy of C. A. Proceedings and original record received.
11	Feb 23 1990		SET FOR ARGUMENT TUESDAY, APRIL 17, 1990. (1ST CASE)
12	Mar 2 1990		Joint appendix filed.
13	Mar 2 1990		Brief of petitioner filed.
14	Mar 23 1990		CIRCULATED.
15	Apr 2 1990	X	Brief of respondent filed.
16	Apr 10 1990	X	Reply brief of petitioner filed.
17	Apr 17 1990		ARGUED.

89-530

Supreme Court, U.S.
FILED
SEP 29 1989
JOSEPH F. SPANIOL, JR.
CLERK

No. ___

IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

PORTLAND GOLF CLUB,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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QUESTIONS PRESENTED

Whether the lower court erred in holding that Petitioner, a tax-exempt social club, may properly deduct losses from a nunmember activity only if it undertakes that activity with the intent to profit, where profit means the production of gains in excess of all variable and properly allocated fixed costs.

Portland Golf Club has no affiliates, parent company or subsidiaries.

PARTIES BELOW

Parties before the United States Court of Appeals for the Ninth Circuit were Portland Golf Club as Appellee and the Commissioner of Internal Revenue as Appellant.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

No. ___

PORTLAND GOLF CLUB

v.

COMMISSIONER OF INTERNAL REVENUE

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

Portland Golf Club, an Oregon non-profit corporation, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit in this case.

OPINIONS BELOW

The opinion of the Court of Appeals (App. A, *infra*) is not reported. The opinion of the United States Tax Court (App. C, *infra*) is not officially reported, but is unofficially reported at P-H Memo T.C, par. 88076.

JURISDICTION

The judgment of the Court of Appeals (App. B, *infra*) was entered on June 1, 1989. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTES INVOLVED

The relevant portions of Sections 511 and 512 of the Internal Revenue Code of 1954 (26 U.S.C.) are set out in a statutory appendix, App. D, *infra*.

STATEMENT

Petitioner is a nonprofit Oregon corporation exempt from tax pursuant to Section 501(c)(7) of the Code. (App. C, 8a.) Since 1914, Petitioner has owned and operated a private club, including a golf course, restaurant, bar, swimming pool and tennis courts, for the benefit of its members, their guests and nonmembers. (App. C, 9a.)

During the fiscal years 1980 and 1981 in issue, Petitioner derived the vast majority of its income from membership dues and other fees paid by members for goods or services provided to the members and/or their guests. Members were allowed to sponsor guests, friends, and organizations to use Petitioner's facilities and services for private parties, receptions or catering (App. C, 10a), and such activities generally generated nonmember income. (App. C, 11a.) In addition, Petitioner followed prudent business standards by retaining funds for improvements and contingencies in the form of short-term investments. (CR 10, No. 12.)[1] The income earned on these investments was also nonmember income. (App. C, 14a.) The total income earned from sales of food and beverages to nonmembers, as well as from investments, constituted

[1] "CR" references are to the docket control numbers assigned to the documents in the original record by the Tax Court Clerk. The appeal was heard on the original record.

Petitioner's total gross unrelated business taxable income. (App. C, 10a.)

In providing food and beverages to nonmembers, Petitioner incurred certain variable expenses (those which vary depending on the amount of food and services provided), such as food and beverage costs, payroll, and other costs. (App. C, 11a.) In connection with providing these goods and services to nonmembers, Petitioner used facilities and personnel which were also used for exempt function purposes. (CR 10, No. 14-15; App. C, 10a.) In preparing its tax returns, Petitioner consistently deducted all of the variable expenses related solely to providing goods and services to nonmembers; it also deducted an allocable portion of the fixed overhead expenses attributable to the facilities and personnel used for both exempt function purposes and non-exempt function purposes, in accordance with Proposed Treasury Regulation Section 1.512(a)-(3)(b)(5).[2] (App. C, 12a.) These fixed overhead expenses consisted of those which were approximately the same amount regardless of the amount of food and related services provided to nonmembers, such as taxes, depreciation, utilities and salaries. (App. C, 11a-12a.)

Since 1975, through and including the years at issue, Petitioner, in its tax returns, has used an allocation formula based on the ratio that nonmember sales bore to total sales, in order to compute the amount of fixed overhead allocated to and deducted from Petitioner's unrelated business taxable income.

[2] This proposed regulation was issued on May 13, 1971 (36 Fed. Reg. 8809), and was withdrawn on January 29, 1987 (52 Fed. Reg. 2724).

(App. C, 12a.) Such method of allocation was stipulated by the parties to be reasonable. (CR 10, No. 14; App. C, 12a-13a.) The parties further stipulated that for the years at issue, an allocable portion of Petitioner's fixed overhead costs was properly attributable and directly connected to the generation of nonmember income. (App. C, 13a.)

Using this "gross-to-gross" allocation formula, Petitioner's unrelated business tax return reported losses on nonmember food and beverage sales of $28,433 for 1980 and $69,608 for 1981. Petitioner offset these losses against its taxable investment income, and reported a net loss in each year. (App. C, 22a.)

Petitioner was concerned about the profitability of private party income, substantially all of which was nonmember business. (CR 14, 7.) It conducted numerous reviews and studies of the profitability of private party income. (CR 10, J.Ex. 6-F, 7-G, 9-I, 10-J, 11-K.) Had Petitioner chosen to allocate fixed overhead for the years at issue based on the square foot and hours of actual use of facilities for the nonmember activities,[3] it would have had net taxable income for income tax purposes from the sale of food and beverages to nonmembers of $19,448 in fiscal 1980 and $23,474 in fiscal 1981. (App. C, 16a.)

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[3] This "actual use" allocation method has been adopted by the Government as an example of a reasonable allocation method in the 1980 and 1982 editions of *Exempt Organizations Continuing Professional Technical Instruction Programs* issued by the Exempt Organizations division of the I.R.S. National Office. This method was also found to be reasonable by the court of appeals in *Rensselaer Polytechnic Institute* v. *Commissioner*, 732 F.2d 1058 (2d Cir. 1984).

Petitioner's activities were run in a businesslike manner, and it kept complete and accurate books and records of its activities. (App. C, 17a.) Its Board of Directors and Finance Committee closely supervised the food and beverage operations, and in 1981 conducted a study showing that the income from sales of food and beverage to nonmembers substantially exceeded all variable costs plus a portion of the dual use fixed costs allocated based upon the number of nonmembers served divided by the total number of people served. (App. C, 18a-19a; CLR 10, J. Ex. 6-9; CR 14, 7-8.) Day-to-day operations were supervised by a manager with substantial club management experience. (App. C, 17a-18a.)

In the Tax Court, Respondent conceded that Petitioner properly allocated its unrelated deductions to income and that such deductions satisfied all requirements of Title I of the Code save one. But Respondent maintained that a club must satisfy the "trade or business" requirement of Section 162 and correlative statutes by establishing it had a profit motive through reporting taxable income on its unrelated business tax return. Petitioner primarily argued that Section 512(a)(3), which defines unrelated business income and deductions for exempt social clubs, does not, as a matter of law, require such a profit motive as a prerequisite to deductions. Alternatively, Petitioner argued that, on the facts presented, it had the appropriate profit motive as defined by settled case law.

The Tax Court did not pass on Petitioner's legal argument, but instead reviewed all the facts and circumstances and held that Petitioner had a profit motive for its sales to nonmembers. It relied on the fact

that Petitioner earned a profit when it computed its nonmember food/beverage income using other permissible accounting methods, although it had continuous losses under the permissible accounting method used on the tax return. (App. C, 35a-37a.) In so holding, the Tax Court relied on its prior unanimous reviewed opinion in *North Ridge Country Club* v. *Commissioner*, 89 T.C. 563 (1987).

The Court of Appeals reversed, in a rationale fully explicated in *North Ridge Country Club* v. *Commissioner*, 877 F.2d 750 (9th Cir. 1989)[4], which had similar facts and was argued and decided with the instant case. Noting that "The issue has produced a conflict of decisions between circuits," the court adopted the rationale of the Second Circuit in *The Brook, Inc.* v. *Commissioner*, 799 F. 2d 833 (2d Cir. 1986). The court rejected the reasoning of the Sixth Circuit in *Cleveland Athletic Club* v. *United States*, 779 F. 2d 1160 (6th Cir. 1985). The Ninth Circuit held that Section 512(a)(3) implicitly contains a "trade or business" and profit motive requirement for a deduction, and disregarded the Sixth Circuit's position that Congress deliberately included these requirements in Section 512(a)(1) which governs deductions of other exempt organizations, but excluded those terms from Section 512(a)(3) which authorizes deductions for exempt social clubs. (*Id.* at 1165.) In the instant case, the Ninth Circuit opinion incorporated by reference its interpretation of Section 512(a)(3) in the *North Ridge* opinion. (App. A, 2a.)

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[4] The taxpayer in *North Ridge* filed a petition for rehearing ~~which is still pending before the Ninth Circuit.~~ the petition was denied on September 27 1989.

The Ninth Circuit in *North Ridge* further held that the club there did not have the requisite profit motive, because the club allegedly conceded that it did not intend to make a profit after taking into account variable and fixed costs. The court rejected the club's contention that income in excess of direct costs alone was profit for trade or business purposes.

In the instant case, however, the court of appeals remanded the case to the Tax Court to determine whether Petitioner had a profit motive, "Because * * * Petitioner could have reported gains in excess of direct and indirect costs, but did not do so, relying on a method of allocation stipulated to be reasonable by the Commissioner * * * ." (App. A, 2a-3a.)

REASONS FOR GRANTING THE PETITION

1. The decision below, holding that Section 512(a)(3) of the Code requires an exempt social club to have an intent to earn a profit, consisting of nonmember food and beverage receipts in excess of nonmember variable and fixed expenses, conflicts with the decision of the Sixth Circuit in *Cleveland Athletic Club* v. *United States*, 779 F. 2d 1160 (6th Cir. 1985). In that case, the court of appeals ruled that a tax exempt social club, which had gross receipts from the sales of food and beverages to nonmembers which exceeded related variable expenses, but which were less than the variable and fixed expenses combined, could offset the resulting tax loss against taxable investment income in computing its unrelated business tax liability. The Court reasoned that the "trade or business" requirement contained in Section 512(a)(1) was deliberately left out of Section 512(a)(3), and that a nonprofit club could deduct all nonmember expenses

as long as the club derived a financial benefit from incurring them, even though the nonmember food/beverage activity generated a tax loss.

The opinion below is also in conflict with the decisions of the courts in *University Club of Cincinnati* v. *United States*, S.D. Ohio No. C-1-88-0443, decided April 21, 1989; *Inter-Com Club* v. *United States*, D. Neb. No. CV88-L-39, decided June 26, 1989; and *Detroit Athletic Club* v. *United States*, E.D. Mich. No. 88-CV-71237-DT, decided July 11, 1989.

On the other hand, the Second Circuit has taken a position similar to the court below. In *The Brook, Inc.* v. *Commissioner*, 799 F.2d 833 (2d Cir. 1986), the court held that a tax exempt club could not offset tax losses from sales of food and beverages to nonmembers, where the club's fixed and variable nonmember expenses exceeded its nonmember income, and it conceded it had no profit motive for such business.

2. The question presented is of substantial importance to the administration of the unrelated business tax provisions as applied to tax exempt social clubs. The National Club Association filed *amicus curiae* briefs in the lower courts, and represents about 750 tax exempt clubs nationwide. It stated that approximately 130 clubs have advised it that Internal Revenue Service agents have proposed unrelated business tax assessments of well over $1 million as a result of disallowing tax losses from nonmember food, beverage, and other unrelated business activities which were taken as deductions. This is undoubtedly only a small fraction of the cases which involve the issue, since the Internal Revenue Service has frequently

stated that there are over 50,000 tax exempt social clubs in the United States.

Other cases involving this issue are pending in the lower courts. We are aware of *Petroleum Club of Houston* v. *United States*, Claims Court No. 153-86T, and *Essex County Country Club* v. *United States*, Claims Court No. 204-86T.

This Court's resolution of the issue is needed in order to equalize treatment of tax exempt social clubs throughout the country. Currently, in the Sixth Circuit clubs are routinely receiving very substantial settlements of their unrelated business tax liabilities, as a result of the decision in *Cleveland Athletic Club* v. *United States, supra*. On the other hand, in most other areas of the country, the Internal Revenue Service is not offering any settlements, and is either holding cases in abeyance or requiring the clubs to litigate their cases in full.

The position taken by the Government in interpreting Section 512(a)(3) is contrary to the Treasury's explanation of the statute when it was presented to Congress for its consideration and vote, and is contrary to the enforcement practice of the Government for the first eleven years following the passage of the statute. Indeed, during the litigation below, the Service withdrew the longstanding Proposed Regulations under Section 512(a)(3), which supported Petitioner's position, leaving taxpayers throughout the country without authoritative guidance on the issue. A decision of this Court is necessary to insure the consistent enforcement of the laws in accordance with the intent of Congress.[5]

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[5] The fact that the Ninth Circuit in this case remanded the

3. The Court of Appeals below erred in the interpretation and application of Section 512(a)(3) of the Internal Revenue Code, App. D, *infra*, which sets forth the formula for determining the unrelated business income and deductions of tax exempt social clubs.

Section 511(a), App.D, *infra*, imposes a tax on the "unrelated business taxable income" of certain organizations that are otherwise exempt from taxation under Section 501(a). Section 512(a)(1), App. D, *infra*, sets forth a *general* definition of "unrelated business taxable income" which is *not* applicable to Petitioner. It provides that "unrelated business taxable income" means the gross income derived by any organization from any unrelated *trade or business* (as defined in Section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such *trade or business* • • • (Emphasis added).

This *general* definition creates for most tax exempt entities a narrow category of taxable income and deductions: those that relate to a *trade or business regularly carried on*. It does not tax income from occasional trade or business activity nor does it tax investment income. The expenses relating to these nontaxable activities are not deductible because they are incurred in producing income which is not subject to tax. IRC Section 265.

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case for determination of whether Petitioner had the requisite type profit motive does not prevent this Court from reviewing the legal issue whether Section 512(a)(3) requires a profit motive, in view of the conflict among the circuits on the latter issue. *United States* v. *General Motors Corp.*, 323 U.S. 373, 374 (1945); *Hanover Star Milling Co.* v. *Metcalf*, 240 U.S. 403, 408-409 (1916); *Forsyth* v. *City of Hammond*, 166 U.S. 506 (1897).

Section 512(a)(3) is a special provision, applicable primarily to tax exempt social clubs. It includes a much broader range of income within its definition of unrelated business taxable income. It defines "unrelated business taxable income" for a Section 501(c)(7) organization as the *gross income* (excluding any exempt function income), less the deductions allowed by this chapter which are directly connected with the production of the *gross income* (excluding exempt function income).

Section 512(a)(1) and Section 512(a)(3) are thus quite different. Section 512(a)(1) defines "unrelated business taxable income" as gross income less related deductions of a "trade or business" regularly carried on by it. It incorporates by specific reference the definition of "trade or business" of Section 513. Section 512(a)(1) was narrowly designed to tax only unrelated "trade[s] or business[es]", because the statute was fundamentally designed to prevent exempt organizations from unfairly competing with taxable businesses. For such organizations, income which did not usually contribute to unfair competition, such as investment income and income from occasional businesses, remained exempt.

In the case of Section 512(a)(3) applicable to social clubs, Congress had an additional goal. Unlike other tax exempt organizations, where the income from unrelated activities is used to further favored societal goals, the unrelated recreational income of a social club is used to reduce the costs members would otherwise pay with after-tax dollars. Congress wanted to treat social clubs in the same manner, for tax purposes, as an aggregate of individuals would be treated when they pooled funds for recreational pur-

poses—member income would be taxed at the individual level, while all other income would be subject to the unrelated business tax.

In 1969, Congress therefore added Section 512(a)(3), which defined "unrelated business taxable income" of a social club broadly to include gross income from any source (other than exempt function income), less the deductions allowed by Chapter 1 of the Code which are directly connected to production of the gross income (other than exempt function income). For purposes of Section 512(a)(3), exempt function income is income received from members for dues, goods or services. The only gross income of a social club which is not subject to tax under Section 512(a)(3) is the income which has been subject to tax at the member level.

It is clear from the legislative history of Section 512(a)(3) that Congress intended to create a new definition of "unrelated *business* taxable income" for social clubs which would include gross income not included in a traditional definition of a "trade or business" and would allow deductions not allowed in the traditional definition of "trade or business" deductions. The House Report accompanying Section 512(a)(3) expressly stated that "all income other than * * * [member income] would be *treated* and taxed as *business* income." H. Rep. No. 413, 91st Cong., 1st Sess. (pt. 1) 47 (1969-3 C.B. 200, 231) (emphasis added). At the time of adoption of the statute, the Treasury Department agreed that this interpretation was intended. In the Treasury Department's explanation of the bill to Congress it stated that "all income, other than that from members in exchange for exempt function facilities, would be included in gross

income, *whether or not the activities generating the income were sufficient to meet the requirements of a trade or business regularly carried on.*"[6] The Treasury's analysis also went on to explain that social clubs need not have a "trade or business" to take deductions under Section 512 (a)(3). It stated that "consistent with the elimination of the 'trade or business regularly carried on' tests, deductions would be allowable if directly connected with *an activity generating income* subject to tax, rather than only if directly connected with an unrelated trade or business * * *."[7]

In the instant case, the Government concedes that Petitioner's tax return has properly allocated the correct amounts and types of nonmember expenses as deductions from unrelated business gross income, and that Petitioner satisfies all the requirements for deductions under both Section 512(a)(3) and the various deduction provisions of the Code, with one exception. The Government and the court below would disallow that portion of the deductions which offset investment income, on the ground that they do not satisfy the "allowed by this chapter" phrase in Code Section 512(a)(3). This phrase assertedly throws the profit motive requirement of Section 162 back into Section 512(a)(3). This Section 162 profit motive test determines whether an activity rises to the level of a trade

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[6] Treasury Tax Reform Studies and Proposals, H. Ways and Means Comm. and S. Fin. Comm. Jt. Pub., Part 3, 319, 324 (Feb. 5., 1969) (emphasis added); *accord*, Technical Explanation of Treasury Tax Reform Proposals, Hearings on Tax Reform before the Comm. on Ways and Means, 91st Cong. 1st Sess., part 14, 5050, 5139-41 (Apr. 22, 1969).

[7] Treasury Tax Reform Studies and Proposals, *supra*, 325.

or business and therefore qualifies for the deduction under Section 162.

This argument fails to give effect to the structure and phraseology of Section 512(a)(3), and its clear legislative history, which eliminated the "trade or business" requirement for both unrelated income and deductions of social clubs. Such a reading improperly prefers the provisions of a general statute over the specific statutory language and legislative history applicable to a specialized taxpayer and institution. See *HCSC* v. *United States*, 450 U.S. 1 (1981). The supersession of Section 162 is particularly erroneous here, since it directly conflicts with Congress' basic purpose in enacting the special definitions of unrelated business income for social clubs in Section 512(a)(3)—to tax income and allow deductions for *all* nonmember activities, including those which do *not* constitute trades or businesses under the general definition of Section 512(a)(1).

As the Tax Court has stated, such an interpretation would "impute a capricious intention to Congress", for it would "tax a social club's nonmember source income, regardless of whether a trade or business was being carried on, but then * * * allow directly related expenses as deductions against such income only if a trade or business was being carried on in such activity." *The Brook, Inc.* v. *Commissioner, supra*, 51 T.C.M. 133, 135 (1985).

4. Even assuming *arguendo* that Section 512(a)(3) incorporates by reference a profit motive test, the Court of Appeals erred in requiring Petitioner to intend to earn a profit, where profit means the production of gains in excess of all variable and fixed overhead costs which are deductible—*viz.*, tax profits. (App. 2a.) The

Tax Court correctly held that Petitioner earned an economic profit and thus had a profit motive, regardless whether Petitioner reported or could have reported taxable income on its return.

The purpose of a profit motive test is to ensure that an activity has as its central purpose economic gain, so that the activity is a "trade or business" rather than an activity designed to satisfy an individual's personal, pleasure, or living purposes. *Cleveland Athletic Club* v. *United States, supra* at *1165; Trustees of Graceland Cemetery Improvement Fund* v. *United States*, 515 F.2d 763 (Ct. Cl.1975); *Anaheim Union Water Co.* v. *Commissioner*, 321 F.2d 253 (9th Cir. 1963).

In the unrelated business tax provisions, the only exemplification of "profit motive" states that the "organization must carry on the activity with the objective that the * * * [activity] will result in *economic profit (without regard to tax consequences.)*" Treasury Income Tax Regulations, Section 1.512(a)-1(f)(7)(ii)(*b*).

The courts have frequently held that "profit" is not the same as taxable income, but means economic profit, independent of tax savings.[8] "Economic profit" is usually different from taxable income,[9] and often

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[8] *Antonides* v. *Commissioner*, 91 T.C. 686, 694 (1988); *Herrick* v. *Commissioner*, 85 T.C. 237, 255 (1985); *Waddell* v. *Commissioner*, 86 T.C. 848, 887 (1986), *aff'd* 841 F.2d 264 (9th Cir. 1988); *Ramsay* v. *Commissioner*, 83 T.C. 793, 810 (1984); *Surloff* v. *Commissioner*, 81 T.C. 210, 233 (1983); *Beck* v. *Commissioner*, 85 T.C. 557, 570 (1985).

[9] See e.g. Treas. Regs. Sections 1.704-1(b)(3)(ii)(*b*) and 1.512(a)-1(f)(7)(ii); *Tolwinsky* v. *Commissioner*, 86 T.C. 1009, 1062 (1986).

means net profits before deductions for fixed costs—*viz.*, cash flow.[10]

An example of the difference between "profit" and "taxable income" was publicized in 1986, when a study showed that numerous major corporations had reported three or four consecutive years of substantial losses for tax purposes, but reported millions of dollars financial profits to their shareholders.[11] Congress acknowledged the difference between profit and taxable income in 1986 by adopting a new minimum tax on "business untaxed reported profits."[12] This provision would not be necessary if profits were identical to taxable income or if the I.R.S. could deny deductions to a corporation merely because the corporation reported several consecutive years of losses for tax purposes.

In the instant case, the Government is trying to collect a few thousand dollars of tax allegedly owed by a small nonprofit corporation, because the club has reported tax losses. But I.R.S. has never contended that it has the right to collect millions of dollars of revenue from large for-profit corporations on the same basis. Moreover, for-profit corporations frequently have losses on some activities—for example, a department store restaurant—which they offset against profits on other activities—for example, the store's retail sales of merchandise. Yet no case or other authority has ever suggested disallowance of such losses because of absence of profit motive. Petitioner merely asks that its taxable activities be taxed using the same economic profit standards applied to for-profit corporations.

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[10] See, e.g., S. Rep. No. 91-552, 91st Cong., 1st Sess. 212 (1969) (1969-3 C.B. 557); H. Rep. No. 91-413, Pt. 1, 91st Cong. 1st Sess. 165 (1969) (1969-3 C.B. 303); H. Rep. No. 94-658, 94th Cong., 2d Sess. 31 (1976-3 C.B. [Vol. 2] 723); *Waddell* v. *Commissioner*, 86 T.C. 848, 884 (Table 10), 887, 894 (1986); *Gefen* v. *Commissioner*, 87 T.C. 1471, 1490-1492 (1986).

[11] A list of such corporations is contained in Citizens for Tax Justice, *130 Reasons Why We Need Tax Reform* (July 1986).

[12] I.R.C. Section 57(f) (1986)

Here, Petitioner had substantial profit on nonmember food and beverage service, computed under three different accounting methods, including at least one favored by the Treasury. (See App. C, 14a-16a, 19a, 20a.) The fact that the admittedly permissible method which Petitioner used in preparing its tax return yielded continuing losses should not negate Petitioner's intent to make a profit.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX

APPENDIX A

Filed June 1, 1989
Cathy A. Catterson, Clerk
U.S. Court of Appeals

NOT FOR PUBLICATION

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

PORTLAND GOLF CLUB,
Petitioner-Appellee,
v.
COMMISSIONER INTERNAL REVENUE SERVICE,
Respondent-Appellee.

No. 88-7218
Tax Ct. No. 13436-85
MEMORANDUM*

Appeal from a Decision of the
Tax Court of the United States

Argued and Submitted March 6, 1989
Portland, Oregon

Before: CANBY, THOMPSON, and LEAVY,
Circuit Judges.

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* This disposition is not appropriate for publication and may not be cited to or by the courts of this circuit except as provided by Ninth Circuit Rule 36-3.

In North Ridge Country Club v. C.I.R., we recently held that a social club's losses from a non-member activity are not deductible under I.R.C. § 512(a) unless that activity was entered into with the intent of producing gains in excess of direct costs (costs related to the non-member activity) and indirect costs (overhead and other fixed expenses). In so doing, we reversed the tax court's decision, since we concluded the court applied the wrong legal standards for profit under Section 512(a).

The tax court decided this case by applying the same standards we rejected in North Ridge. Because Portland Golf Club could have reported gains in excess

of direct and indirect costs, but did not do so, relying on a method of allocation stipulated to be reasonable by the Commissioner, we REMAND this case to the tax court for a determination of whether Portland Golf Club engaged in its non-member activities with the intent required under North Ridge to deduct its losses from those activities.

REMANDED.

APPENDIX B

UNITED STATES COURT OF APPEALS

For the Ninth Circuit

PORTLAND GOLF CLUB, Petitioner-Appellee,	CA No. 88-7218
v.	Tax Ct No. 13436-85
COMMISSIONER INTERNAL REVENUE SERVICE Respondent-Appellant	**JUDGMENT** MANDATE ISSUED Jun 23, 1989

Upon Petition to Review a Decision of the Tax Court of the United States, _____

_____

This Cause came on to be heard on the Transcript of the Record from the Tax Court of the United States,_____

_____

_____

___and was duly submitted.

On Consideration Whereof, it is now here ordered and adjudged by this Court, that the _____ Decision of the said Tax Court of the United States in this Cause be, and hereby is REMENDED

Filed and entered June 1, 1989

APPENDIX C

T.C. Memo. 1988-76

UNITED STATES TAX COURT

PORTLAND GOLF CLUB,
Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

Docket No. 13436-85.

Filed February 24, 1988.

Allen B. Bush, for the petitioner.[1]

Gerald W. Douglas, for the respondent.

[1] An amicus curiae statement was filed by Leonard J. Henzke, Jr., as counsel for The National Club Association.

MEMORANDUM FINDINGS OF FACT AND OPINION

SCOTT, Judge: Respondent determined deficiencies in petitioner's income taxes for its fiscal years ending September 30, 1980, and September 30, 1981, in the amounts of $1,828 and $3,470, respectively. The issue for decision is whether petitioner, a social club exempt from tax under Section 501(c)(7)[2], may offset against unrelated business taxable income from interest, an amount which represents the excess of its deductions

[2] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the years here in issue. Rule references are to the Tax Court Rules of Practice and Procedure.

over receipts from sales of food and beverages to nonmembers.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly:

Petitioner, the Portland Golf Club, is and at all times relevant to the issues involved in this case, has been a nonprofit Oregon corporation exempt from Federal income tax under the provisions of Section 501(c)(7). At the time of filing its petition herein, petitioner's principal office was located in Portland, Oregon. For each of its fiscal years ending September 30, 1980, and September 30, 1981, petitioner filed a Form 990-T, Exempt Organization Business Income Tax

Return, and a Form 990, Return of Organization Exempt From Income Tax.[3]

Since 1914, petitioner has owned and operated a private golf and country club with a golf course, restaurant and bar, swimming pool, and tennis courts for the benefit of its members, their guests, and nonmembers on a restricted basis. Petitioner's purpose is, and during the years here in issue was, to operate a golf club, restaurant, bar and party facility, swimming pool, and tennis

---

[3] The return for petitioner's fiscal year ending September 30, 1980 was a return for a short taxable year of eleven months. Prior to this fiscal year petitioner had a fiscal year ending October 31, but applied for and received authority to change to a fiscal year ending September 30, 1980, resulting in the return for its fiscal year 1980 being for the period November 1, 1979 through September 30, 1980.

courts for the benefit of its members and their guests. Petitioner's exempt activities are the provision of entertainment, dining, and athletic recreation to its members.

During the years in issue petitioner also conducted certain nonexempt activities. During these years petitioner's nonexempt function income was derived from investments which resulted in interest income and from the sales of food and beverages to nonmembers.

Petitioner's members are allowed to sponsor guests, friends, and organizations who wish to use petitioner's facilities and services for private parties, receptions, or catering. Petitioner's nonmember food and beverage

income resulted when these activities did not meet the requirements of Section 512 of the Income Tax Regs. and respondent's ruling thereunder. Petitioner's nonmember food and beverage income from these activities constitutes unrelated business taxable income.

Petitioner incurred variable expenses such as food and beverage costs, payroll, and other expenses in connection with its nonmember sales of food and beverages, as well as overhead and other fixed expenses. Petitioner's overhead and other fixed expenses for the sale of food and beverages to nonmembers consisted of items such as administration, taxes, insurance, and depreciation (hereinafter "fixed expenses"). These fixed expenses would be incurred by petitioner whether

petitioner served nonmembers or not. On its returns' Forms 990-T, petitioner has consistently deducted an allocable portion of overhead and fixed expenses from nonmember income in accordance with Prop. Income Tax Regs. Section 1.512(a)-(3)(b)(5).[4] Since 1975, through and including the years here in issue, petitioner has used an allocation formula based on the ratio that nonmember sales bore to total sales to compute the amount of overhead and fixed expenses allocated to and deducted from petitioner's unrelated business taxable income on its returns. Such method of allocation is

[4] This proposed regulation was withdrawn as of January 23, 1987 by notice published on January 26, 1987 in the Federal Register. 52 Fed. Reg. 2724-2725.

reasonable.[5] For the years at issue an allocable portion of petitioner's overhead costs was properly attributable and directly connected to the generation of nonmember income. Using this method of reporting, petitioner has, since 1975 and up to its fiscal year 1984, incurred losses for tax purposes from the sale of food and beverages to nonmembers and has reported these losses on its Form 990-T returns. Many of petitioner's expenses are fixed expenses relating to maintenance and minimum staff requirements of operating its facilities.

Petitioner's prices for the sales of food and beverages to nonmembers were in

[5] The parties stipulated to this fact in the exact language used in this opinion.

excess of the prices of food and beverages served to members. Petitioner, in determining the prices to be charged for food and beverages to be served to nonmembers attempted to arrive at amounts which would result in the amount received from these sales being in excess of all variable costs directly related to such sales. The variable costs considered were items such as the food costs, supplies, beverage costs and labor costs. Petitioner priced sales of food and beverages to nonmembers so that the cost of food was about 30 percent to 33 percent of the selling price of the meal. Had petitioner chosen to allocate fixed overhead for the years here in issue based on actual use of facilities, it would have had net taxable income for

income tax purposes from the sale of food and beverages to nonmembers as shown by the following schedule:

	11 Months Ending 9/30/80			Year Ending 9/30/81		
	Dining Room	Bar	Total	Dining Room	Bar	Total
Sales	$68,122	$16,300	$84,422	$85,134	$21,413	$106,547
Variable expenses:						
Food & Liquor	27,249	5,183	32,432	34,054	6,617	40,671
Labor & Other Related Costs	14,540	5,281	19,821	16,868	7,259	24,127
Other	8,362	1,206	9,568	11,853	1,756	13,609
	$50,151	$11,670	$61,821	$62,775	$15,632	$78,407
Excess of Sales over Variable Expenses	$17,971	$ 4,630	$22,601	$22,359	$ 5,781	$28,140
Fixed Expenses	3,153	0 *	3,153	4,666	0 *	4,666
Profit	$14,818	$ 4,630	$19,448	$17,693	$ 5,781	$23,474

* Fixed expenses are included under Dining Room.

From its fiscal year 1975 through its fiscal year 1984, the preparation of petitioner's From 990-T, Exempt Organization Business Income Tax Returns, in accordance with the Prop. Income Tax Regs., Section 1.512(a)-3(b)(5), resulted in losses for tax purposes from the sale of food and beverages to nonmembers.

Petitioner's activities were run in a business-like manner and it kept complete and accurate books and records of its activities. Petitioner's operations were overseen by a board of directors (board) of nine members which met at least monthly. The board supervises and reviews the actions of the full-time, professional, general manager, who controls the operations and implements board policy on a day-to-day

basis. During the years at issue, petitioner's board was made up of business people and professionals from various backgrounds. Petitioner's board, finance committee, and staff, in a number of instances, discussed and dealt with the problems relating to petitioner's food and beverage sales, and in these discussions, considered these food and beverage operations as important to petitioner's overall financial operations. From time to time the board discussed the nonmember food and beverage sales of petitioner. Petitioner had a standing finance committee which met monthly to review financial statements, conduct studies concerning the financial aspect of petitioner's operations, and generally to discuss the implementing of

board policy in the area of financial matters. Under date of August 12, 1981, the finance committee addressed a memorandum to the board attaching an analysis of the dining room operations of petitioner. In the analysis, the committee pointed out that whereas ordinary meals served to members at the club resulted in a loss, amounts received from private party functions including nonmember functions, generated higher than average sales and resulted in a profit. One of the conclusions in this report was that since nonmembers spend more than members per meal, the club should increase the number of nonmember meals served each month, and should encourage club members to bring in individuals and other nonmembers for

lunches, dinners and special functions. Subsequently, various other studies were made of the food operations which considered ways of encouraging private parties of members and nonmember activities.

During the years here in issue the manager of petitioner was an individual with a bachelor of science degree in hotel and restaurant administration and a bachelor of science degree in recreation administration. This manager had previous employment with hotels and private clubs. The manager was a certified club manager and had served as an officer of the local chapter of Club Managers' Association of America, as well as a state director of Restaurants of Oregon Association. The price of food

and beverages at nonmember activities was set by the board and the club management at an amount intended to result in a profit to the club over the direct cost associated with the activity. In addition, these activities were intended to attract additional members to the club, resulting in additional income from initiation fees, and to sharpen the skills of the chef and his staff.

During its fiscal year ended September 30, 1980, petitioner received investment income in the form of interest in the amount of $11,752. This interest constituted unrelated business taxable income to petitioner. During its fiscal year ended September 30, 1981, petitioner received investment income in the form of interest in the amount of $21,414, which

also constituted unrelated business taxable income to petitioner. On its Forms 990-T filed for its fiscal years ended September 30, 1980 and September 30, 1981, petitioner showed a loss on food and beverage sales of $28,433 and $69,608, respectively, computed on the basis of deducting an allocable portion of overhead and fixed expenses from nonmember income based on the percentage of nonmember sales to total sales in accordance with proposed Income Tax Regulations, Section 1.512(a)-3(b)(5). Respondent in his notice of deficiency to petitioner included in petitioner's income the interest income received in its fiscal years 1980 and 1981 and disallowed the deductions claimed in those years for losses on food and

beverage sales to nonmembers, as well as the loss carryovers which petitioner claimed based on losses on nonmember food and beverage sales for prior years. Respondent explained the disallowance of the food and beverage losses by stating that--

> food and beverages are being sold to nonmembers at prices insufficient to cover the cost of such sales. These sales have consistently over a number of years only resulted in losses, consequently it is determined that such sales are not profit-motivated and any net loss cannot be deducted in computing unrelated business taxable income.

A similar explanation with respect to nonmember sales in prior years was given for the disallowance of the loss carryovers.

OPINION

Respondent's position in this case is that petitioner's losses, properly computed under his proposed Regulations, from the sale of food and beverages to nonmembers are not deductible by petitioner in determining its unrelated business taxable income since the expenses causing these losses were not incurred in a trade or business carried on for profit and, therefore, are not deductible as business expenses under Section 162. Respondent takes the position that the fact that petitioner shows a profit from the sale of food and beverages to nonmembers when the income from that activity is computed by determining deductible variable expenses on a percentage of use of facilities

basis, is immaterial to determining whether it had a profit motive in conducting that activity, since petitioner actually reported the losses from this activity by allocating the fixed expenses in another acceptable manner.

It is further respondent's position that the primary motivation of petitioner's nonmember business activities was to provide a financial benefit to its members in that the revenues from the sales of food and beverages to nonmembers reduce the need for increasing members' assessments or increasing members' prices. Respondent concludes that since petitioner had no objective expectation of recovering all directly allocable expenses of its

nonmember sales, it did not engage in the selling of food and beverages to nonmembers with a profit motive. Respondent contends that absent a profit motive, petitioner's nonmember sales of food and beverages do not constitute a trade or business and therefore the expenses connected with this activity are not deductible by petitioner under Section 162. Respondent argues that for this reason it is improper to use the losses reported by petitioner from its food and beverage sales to nonmembers to reduce its unrelated business taxable income from interest in each of the years here in issue.

Petitioner, in answer to respondent's contentions, argues that since Section 512(a)(3)(A) defines certain income of

nonprofit social clubs as "unrelated business taxable income" expenses directly connected with the production of that business related income are by definition expenses incurred in a trade or business which meets the requirements of Section 162. Petitioner argues that for this reason the profit motivation test is not applicable in determining whether an activity conducted by a nonprofit social club is a trade or business. Petitioner further argues that in any event it did intend to make a profit and did make a profit on its nonmember food and beverage sales. Petitioner concludes that it therefore properly aggregated income and expenses from all nonexempt sources to arrive at its unrelated business taxable income.

Petitioner, a tax exempt social club, under the provisions of Section 501(c)(7) is generally exempt from income tax under Section 501(a). However, as a nonexempt social club, petitioner is subject to the tax imposed by Section 511 on unrelated business taxable income pursuant to Section 501(b). The term unrelated business taxable income is defined in Section 512(a)(1).[6] Section 512(a)(3)

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[6] Sec. 512(a)(1) provides as follows:

(1) General Rule.--Except as otherwise provided in this subsection, the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (as defined in Section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

sets forth specific provisions with respect to the unrelated business taxable income of social clubs.[7] Section 512(a)(3)(B)[8] defines exempt function

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[7] Sec. 512(a)(3)(A) provides as follows:

(A) General Rule.--In the case of an organization described in Section 501(c)(7) or (9), the term "unrelated business taxable income" means the gross income (excluding any exempt function income), less the deductions allowed by this chapter which are directly connected with the production of the gross income (excluding exempt function income), both computed with the modifications provided in paragraphs (6), (10), (11), and (12) of subsection (b). * * *

[8] Sec. 512(a)(3)(B) provides as follows:

(B) Exempt Function Income.--For purposes of subparagraph (A), the term "exempt function income" means the gross income from dues, fees, charges, or similar amounts paid by members or the organization as consideration for providing such members or their dependents or guests goods, facilities, or services in furtherance of the purposes constituting the basis for the

income as the gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members or their dependents or guests goods, facilities, or services in furtherance of the purposes constituting the basis for the exemption of the organization to which such income is paid.

It is clear therefore, and neither party argues to the contrary, that amounts paid to petitioner by its members whether by assessment, dues, fees, or for

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exemption of the organization to which such income is paid. Such term also means all income (other than an amount equal to the gross income derived from any unrelated trade or business regularly carried on by such organization computed as if the organization were subject to paragraph (1), which is set aside * * * .

meals, are exempt income but that all other income received by petitioner is unrelated business taxable income. Its income from sales to nonmembers is by definition unrelated business taxable income. Petitioner argues that because of this definition and the legislative history of Section 512, it follows that it is not necessary that an activity by a social club be a trade or business in the ordinary sense of that term as used in Section 162 to constitute an unrelated taxable income activity of such club. Petitioner argues that respondent in taking a position to the contrary ignores the definition of business taxable income and business activity contained in Section 512. Respondent argues that petitioner is incorrect in its

interpretation of the statute, since the statute specifically provides that the unrelated business taxable income means the gross income less deductions "allowed by this chapter" which are directly connected with the production of gross income. It is respondent's position that deductions "allowed by this chapter" means deductions under Section 162 and that in order for items to be deductible under Section 162 they must be incurred in connection with a trade or business. Respondent in support of his position cites the case of Brook, Inc. v. Commissioner, 799 F.2d 833 (2d Cir. 1986), which affirmed in result a Memorandum Opinion of this Court. Respondent in his brief recognizes that the decision of the Second Circuit in

Brook, Inc. v. Commissioner, supra, might be considered contrary to the decision in Cleveland Athletic Club, Inc. v. United States, 779 F.2d 1160 (6th Cir. 1985). Recently, in a Court-reviewed opinion, we discussed the holding of the Court in Brook, Inc. v. Commissioner, supra, as well as the holding in Cleveland Athletic Club, Inc. v. United States, supra. See North Ridge Country Club v. Commissioner, 89 T.C. 563 (1987). In the North Ridge Country Club case we concluded that it was unnecessary for us to choose between the positions with respect to Section 512(a)(3) taken in Brook, Inc. v. Commissioner, supra and Cleveland Athletic Club, Inc. v. United States, supra, since we had found in the case there under consideration that the

taxpayer's sales of food and beverages to nonmembers were made with a profit motive.

The situation here with respect to food and beverage sales is indistinguishable from the situation involved in North Ridge Country Club v. Commissioner, supra.[9] Petitioner had a

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[9] In fact, after the filing of the opinion in North Ridge Country Club v. Commissioner, 89 T.C. 563 (1987), petitioner forwarded a copy of the opinion to the Court with a letter that stated in part as follows:

> Enclosed please find a copy of the recent Tax Court decision in North Ridge Country Club v. CIR. As you recall, this case involved similar issues as the above-referenced case.
>
> * * *
>
> At present, I do not think additional argument need be made in the Portland Golf Club case other than to say that we concur with the decision in North Ridge Country Club and its rationale.
>
> If, upon reflection, I think further argument would clarify any issue of our case in light of the North Ridge Country Club case, I would petition the court for leave to file a supplemental brief.

A copy of petitioner's letter to the Court with its attachment was sent to respondent's counsel but respondent's counsel did not request that he be permitted to file any further brief in an attempt to distinguish the North Ridge Country Club case from the instant case.

profit from its sales of food and beverages to nonmembers if only the direct costs incurred in connection with those sales are deducted from the receipts from such sales and also had a profit if a further deduction is made for fixed expenses on a use of space allocation. The fixed costs which petitioner deducted to arrive at the loss

for tax purposes were costs which the club would have to pay whether or not it had sales to nonmembers, allocated on a basis of total nonmember sales as compared to total member sales.[10]

We held on the facts in North Ridge Country Club v. Commissioner, supra, that the taxpayer did have a profit motive in its nonmember food and beverage sales activity. Clearly in this case,

[10] Since food and beverages sold to nonmembers were sold at prices in excess of food and beverages sold to members this result is not surprising but rather might well be anticipated. Respondent has stipulated in this case, however, that this method of allocation is proper and acceptable in computing petitioner's unrelated business taxable income from food and beverage sales. We therefore have not considered whether the facts in this case support such an expense allocation in arriving at income or loss from nonmember food and beverage sales for income tax purposes.

petitioner likewise had a profit motive in its nonmember food and beverage sales activity. It did intend to make a profit, and did make a profit between the amount received from sales to nonmembers and the costs related to those sales which would not have been incurred absent those sales.[11] It is only by allocating a part of the expenses which petitioner

[11] We have not ignored respondent's statement that this is not a fact for petitioner's fiscal year 1981. However respondent bases this statement on a schedule in petitioner's Form 990-T for its fiscal year 1981 which did not properly segregate costs which would not have been incurred absent the nonmember sales from other costs. The evidence clearly shows that petitioner had income from nonmember sales based on deducting from such sales only expenses which would not have been incurred absent such sales and respondent does not seriously contend to the contrary.

would have in all events incurred on a sales ratio basis, permitted by respondent, to the sales to nonmembers, that a loss results.

In North Ridge Country Club v. Commissioner, supra, we stated with respect to respondent's argument that profit motive on any allocation of fixed expenses other than the allocation method used on the taxpayer's returns was immaterial in determining the taxpayer's profit motive as follows (89 T.C. at 572-573):

> Respondent contends, however, that we must look to taxable income in order to determine whether there is profit motivation. He argues that since petitioner is allowed to deduct an allocable portion of the fixed or indirect costs in arriving at unrelated business taxable income, petitioner should also be required to take these costs into consideration in regard to determining profit motivation. Petitioner is, in

> effect, says respondent, having it both ways. While there is a certain pleasing symmetry to respondent's argument, we do not believe it to be determinative of the question before us.18/ The record as a whole makes it apparent that petitioner was seeking profit from these activities and we so hold.

18/ We note that it is respondent who allows the deduction of the indirect fixed costs against the nonexempt income; costs which otherwise would be borne in their entirety by the club membership.

Respondent argues that to permit petitioner to offset the loss from its nonmember sales of food and beverages computed in accordance with respondent's proposed regulations against other unrelated business taxable income, in effect, permits petitioner to use these nonmember activities to cause its dues, assessments, and meal costs to its members to be less. It is respondent's

members to be less. It is respondent's position that it was to avoid such a result that Congress enacted the special provision with respect to unrelated business taxable income for social clubs exempt from tax under Section 501(c)(7). This same argument was made by respondent in North Ridge Country Club v. Commissioner, supra, and was rejected.

*** Likewise respondent's reliance on Ye Mystic Krewe of Gasparilla v. Commissioner, 80 T.C. 755 (1983), is misplaced. The facts in that case differ substantially from the facts in the instant case. In that case as we explained in North Ridge Country Club v. Commissioner, supra, we held that the taxpayer could not offset its expenses of staging a mock invasion of Tampa and a

and beverages to nonmembers results in a loss when the costs related thereto including a pro rata part of fixed expenses (computed by a method respondent agrees is acceptable) are considered.

In our view there is no distinction between the instant case and the situation we considered in North Ridge Country Club v. Commissioner, supra, a Court-reviewed case. Based on our reasoning and holding in that case, and for the reasons set forth herein, we hold that petitioner is entitled to offset its unrelated business taxable income from interest by its loss from its nonmember food and beverage sales computed by allocating a portion of its fixed expenses to the nonmember food and

beverage sales activity in a manner which respondent agrees is acceptable.[12]

Decision will be entered for the petitioner.

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12 Respondent does not argue in this case as he did in North Ridge Country Club v. Commissioner, 89 T.C. 563 (1987), that petitioner is not entitled to offset a loss from one of its unrelated business taxable income activities against a profit from another such activity. Here respondent only argues that the loss from petitioner's nonmember food and beverage sales should not be offset against the interest unrelated business taxable income because the nonmember food and beverage sales activity was not engaged in with a profit motive. Since we have concluded that the activity was further, based on respondent's argument, whether the excess of expenses over income from the nonmember sales of food and beverages may be deducted from the interest income received by petitioner.

APPENDIX D

INTERNAL REVENUE CODE OF 1954
(26 U.S.C.) § 511 (a)

Sec. 511. IMPOSITION OF TAX ON UNRELATED BUSINESS INCOME OF CHARITABLE, ETC., ORGANIZATIONS.

(a) Charitable, Etc., Organizations Taxable at Corporation Rates. --

(1) Imposition of tax. -- There is hereby imposed for each taxable year on the unrelated business taxable income (as defined in section 512) of every organization described in paragraph (2) a tax computed as provided in section 11. In making such computation for purposes of this section, the term "taxable income" as used in section 11 shall be read as "unrelated business taxable income."

§ 511 (cont.)

(2) Organizations subject to tax. --
(A) Organizations described in sections 401(a) and 501(c). -- The tax imposed by paragraph (1) shall apply in the case of any organization (other than a trust described in subsection (b) or an organization described in section 501(c)(1) which is exempt, except as provided in this part or part II (relating to private foundations), from taxation under this subtitle by reason of section 501(a).

Internal Revenue Code of 1954 (26 U.S.C.) §512(a)_

§512. Unrelated business taxable income
(a) Definition. -- For purposes of this title --
(1) General rule. -- Except as otherwise provided in this subsection, the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

* * *

§ 512 (a) (cont.)

(3) Special rules applicable to organizations described in section 501(c)(7) or (9). --

(A) General rule. -- In the case of an organization described in section 501(c)(7) or (9), the term "unrelated business taxable income" means the gross income (excluding any exempt function income), less the deductions allowed by this chapter which are directly connected with the production of gross income (including exempt function income), both computed with the modifications provided in paragraphs (6), (10), (11), and (12) of subsection (b). For purposes of the preceding sentence, the deductions provided by sections 243, 244, and 2345 (relating to dividends received by corporations) shall be treated as not directly connected with the production of gross income.

§ 512 (a) (cont.)

(B) Exempt function income. -- For purposes of subparagraph (A), the term "exempt function income" means the gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members or their dependents or guests goods, facilities, or services in furtherance of the purposes constituting the basis for the exemption of the organization to which such income is paid. Such term also means all income (other than an amount equal to the gross income derived from any unrelated trade or business regularly carried on by such organization computed as if the organization were subject to paragraph (1)), which is set aside --

§ 512 (a) (con't)

(i) for a purpose specified in section 170(c)(4), or

(ii) in the case of an organization described in section 501(c)(9), to provide the payment of life, sick, accident, or other benefits, including reasonable costs of administration directly connected with a purpose described in clause (i) or (ii).

If during the taxable year, an amount which is attributable to income so set aside is used for a purpose other than that described in clause (i) or (ii), such amount shall be included, under subparagraph (A), in unrelated business taxable income for the taxable year.

Supreme Court, U.S.
FILED
DEC 20 1989
JOSEPH F. SPANIOL, JR.
CLERK

(2)

No. 89-530

In the Supreme Court of the United States

OCTOBER TERM, 1989

PORTLAND GOLF CLUB, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT

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18 pp

QUESTION PRESENTED

Where a tax-exempt social club earns gross income from the sale of food and drink to nonmembers but reports a net loss from that activity because the total expenses allocated to it (both fixed and variable) exceed the gross income, whether the club can offset that loss against its net investment income in determining its "unrelated business taxable income" (26 U.S.C. 511-512) if the club lacks a profit motive in engaging in the sales to nonmembers because it does not intend that activity to generate income in excess of the total expenses allocated to it.

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In the Supreme Court of the United States

OCTOBER TERM, 1989

No. 89-530

PORTLAND GOLF CLUB, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-3a) is unreported. The memorandum opinion of the Tax Court (Pet. App. 6a-42a) is unofficially reported at 55 T.C.M. (CCH) 212.

JURISDICTION

The judgment of the court of appeals (Pet. App. 4a-5a) was entered on June 1, 1989. On August 28, 1989, Justice O'Connor extended the time within which to file a petition for a writ of certiorari to and including September 29, 1989, and the petition was

filed on September 28, 1989. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner is a corporation exempt from income tax as a "social club" under Section 501(c)(7) of the Internal Revenue Code,[1] which grants tax-exempt status to "[c]lubs" that are "organized for pleasure, recreation, and other nonprofitable purposes" and meet certain other requirements. Petitioner operates a private country club that has a golf course, restaurant and bar, swimming pool, and tennis courts, primarily for the use of members and their guests. Nonmembers who are sponsored by members are permitted to use petitioner's restaurant and bar for banquets, receptions, and similar functions. Petitioner receives gross income that is unrelated to its exempt purposes—and hence subject to unrelated business income tax under Sections 511-512 of the Code—from two sources: sales of food and drink to nonmembers and interest upon its investments. Pet. App. 8a-11a.[2]

---

[1] Unless otherwise noted, statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as in effect during 1980 and 1981, the tax years involved.

[2] The Code imposes a tax, at regular corporate rates, on an exempt organization's "unrelated business taxable income." I.R.C. § 511. The "unrelated business taxable income" of a social club is defined by Section 512(a)(3)(A) as "the gross income (excluding any exempt function income), less the deductions allowed by this chapter which are directly connected with the production of the gross income * * *." Because the "exempt function income" is confined to membership dues and other receipts from members (see I.R.C. § 512(a)(3)(B)), all of the income that a social club receives from nonmembers, as well as interest and dividends that accrue upon its investments, is subject to unrelated business income tax, whether or not the income derives from a trade or business. This treatment differs from that accorded by the Code to most other tax-exempt organizations, including charitable organizations granted exemption by Section 501(c)(3), whose "unrelated business taxable income" as defined by Section 512(a)(1) is limited to earnings from an "unrelated trade or business." See *United States* v. *American College of Physicians*, 475 U.S. 834, 837-839 (1986); *United States* v. *American Bar Endowment*, 477 U.S. 105, 109-110 (1986).

On its tax returns for 1980 and 1981, petitioner computed its gain or loss from the nonmember sales by deducting direct expenses (such as food and beverage costs, payroll, and supplies) that varied with the volume of the sales, and by deducting an allocable share of other, indirect expenses (such as taxes, depreciation, insurance, and other fixed overhead) that it would have incurred to operate its facilities whether or not it served nonmembers. The indirect expenses were allocated to the nonmember sales based on the ratio of petitioner's gross receipts from nonmember sales to its total gross receipts from sales of food and drink. Pet. App. 11a-13a. Petitioner's gross income from the nonmember sales exceeded the direct expenses of that activity, but was less than the sum of the direct and allocated indirect expenses, thereby generating net losses of $28,433 for 1980 and $69,608 for 1981 from its nonmember sales.[3] Those losses were greater than its interest income for those years. Petitioner offset the losses against the interest income, and it reported no unrelated

---

[3] Petitioner likewise reported net losses from nonmember sales on its tax returns for every other year from 1975 through 1984 (Pet. App. 13a).

business income tax liability for 1980 or 1981. *Id.* at 21a-22a.

On audit, the Commissioner determined that the expenses allocated to nonmember activities were deductible by petitioner only to the extent of its income from those activities, but could not be used to offset its investment income. Accordingly, he asserted tax deficiencies of $1,828 for 1980 and $3,470 for 1981 to reflect the tax due on petitioner's investment income. Pet. App. 7a. The Commissioner reasoned that the expenses of nonmember activities are deductible to the extent they exceed income from such activities only if petitioner carries on the nonmember sales activity with a profit motive.[4] He found that petitioner lacked a profit motive for the nonmember activity because the prices of the food and drink were insufficient to recover the total costs allocated to such activities, so that such sales consistently yielded net losses. *Id.* at 22a-23a.

2. Petitioner challenged the Commissioner's determination in the Tax Court, which ruled in its favor (Pet. App. 6a-42a). The court held that the expenses allocable to petitioner's nonmember activities were

[4] The general rule under the income tax law is that the expenses of a not-for-profit activity may be offset against the income from that activity, but excess expenses may not be applied against income from other sources. See I.R.C. § 183; *Five Lakes Outing Club* v. *United States*, 468 F.2d 443, 446 (8th Cir. 1972) (allowance of expenses up to, but only up to, gross income from the related not-for-profit activity is "the procedure the Commissioner has long used with court approval"). Sections 163 and 164 of the Code, however, do permit the deduction of interest and taxes whether or not the taxpayer engages in the activity with a profit motive.

deductible in full.[5] Assuming (without deciding) that petitioner could deduct against other income its expenses from nonmember sales only if that activity was profit-motivated, the court found that standard satisfied because petitioner intended that the gross receipts from the nonmember sales would exceed the related "direct costs" (*id.* at 35a), *i.e.*, "the costs related to those sales which would not have been incurred absent those sales" (*id.* at 37a). See *id.* at 34a-42a. The court stated that the net losses consistently reported on petitioner's tax returns were not evidence that the sales lacked a profit motive, because those losses resulted "only by allocating a part of the expenses which petitioner would have in all events incurred," *i.e.*, the indirect expenses (*id.* at 37a-38a). Thus, although petitioner had allocated a portion of its fixed overhead expenses to its nonmember activity in order to generate the tax losses from that activity that it sought to deduct, the court permitted it to ignore those overhead expenses in determining whether it had the requisite profit motive with respect to the nonmember activity to claim such deductions (see *id.* at 38a-39a). The Tax Court relied heavily on its reviewed decision in *North Ridge*

[5] To be deductible under Section 512(a)(3), expenses must be "directly connected" with the conduct of the unrelated business activity. Under Treas. Reg. § 1.512(a)-1(c), where expenses are incurred or facilities are used for both exempt and nonexempt purposes, an allocation of depreciation, overhead, and similar expenses must be made on a reasonable basis. Once such expenses are so allocated to the nonmember activity, they are treated as if they are directly connected to the nonmember activity. The Commissioner did not challenge the allocation made by petitioner in this case; the parties stipulated that the allocation was reasonable (Pet. App. 12a-13a & n.5, 36a n.10).

Country Club v. *Commissioner*, 89 T.C. 563 (1987), rev'd, 877 F.2d 750 (9th Cir. 1989), where it had ruled that it would not evaluate a club's profit motive from the standpoint of "*taxable* profit," but would look instead to the "incremental increase in available funds" realized by the club from the activity (89 T.C. at 572).

3. The court of appeals reversed and remanded, on the authority of its opinion reversing the Tax Court in *North Ridge* (Pet. App. 1a-3a). In *North Ridge*, the court of appeals had noted that the question whether Section 512(a)(3) permits a social club to deduct expenses allocable to nonmember activity that lacks a profit motive "has produced a conflict of decisions between circuits" (877 F.2d at 753). Compare *Cleveland Athletic Club, Inc.* v. *United States*, 799 F.2d 1160, 1165 (6th Cir. 1985) (net losses allowable if nonmember activity carried on for "economic gain"), with *The Brook, Inc.* v. *Commissioner*, 799 F.2d 833, 839 (2d Cir. 1986) ("disagree[ing]" with Sixth Circuit's analysis because "a switch to an 'economic gain' test would give social clubs a tax advantage not enjoyed by other taxpayers"). The Ninth Circuit rejected the "economic gain" test of *Cleveland Athletic Club*, and agreed with *The Brook* that "a social club must pursue a nonmember activity with a profit motive before it can properly deduct its losses under section 512(a)" (877 F.2d at 754). The court grounded that conclusion upon the language of the statute, which limits a social club's deductions to those "allowed by this chapter," and upon the statute's legislative history, which it interpreted as requiring a social club's nonexempt income to be taxed according to the same principles that apply generally to all taxpayers under the Code. In particular, the court found that Section 512(a)(3) incorporates the principles of Section 162, under which expenses of the kind claimed by petitioner are not deductible (to the extent they exceed income) unless the business is conducted with a profit motive. *Ibid.*

The Ninth Circuit in *North Ridge* proceeded to hold that the profit motive test imposed as a condition to deducting excess expenses of a nonmember activity under Section 512(a)(3) is not satisfied unless a social club conducts that activity for "the production of gains in excess of all direct and indirect costs" (877 F.2d at 756). The court specifically rejected the Tax Court's view that a club's "intent to derive economic benefit from nonmember activity, before considering indirect costs," can satisfy the profit motivation requirement of the statute (*ibid.*). The court concluded that the Tax Court's interpretation of the statute would erroneously allow a portion of the club's nonexempt income to go untaxed, thus "manifestly" producing "the sort of tax-free subsidy to social club members that section 512(a) sought to prevent" (*ibid.*).

In this case, the court of appeals stated that the Tax Court had "appl[ied] the same standards we rejected in *North Ridge*," and accordingly it reversed (Pet. App. 2a). The court remanded to the Tax Court "for a determination of whether [petitioner] engaged in its non-member activities with the intent required under *North Ridge* to deduct its losses from those activities" (*id.* at 3a).[6]

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[6] Petitioner had argued in the Tax Court that it could have shown a net profit on its nonmember sales if it had chosen a different method of allocating the indirect costs to that activity—specifically, if it had allocated the costs according to actual use of facilities instead of gross receipts.

DISCUSSION

The court of appeals correctly held that petitioner, in computing its "unrelated business taxable income" under Section 512(a)(3), may not deduct the expenses allocable to its nonmember sales to the extent they exceed the income from such activities, unless the sales are carried out with an intent to make a profit. The court also correctly held that "profit" in this context means an excess of gross income over all properly allocated expenses, fixed as well as variable. We agree with petitioner, however, that there exists a conflict in the circuits on this issue; the decision below cannot be squared with *Cleveland Athletic Club, Inc.*, v. *United States*, 779 F.2d 1160, 1165 (6th Cir. 1985). Because this conflict involves a recurring issue of substantial administrative importance, we do not oppose the granting of certiorari.

1. Section 512(a)(3) does not independently establish certain expenses as deductible by a social club. Rather, it permits a social club to reduce its gross income by "the deductions *allowed by this chapter* which are directly connected with the production of the gross income" (emphasis added). Thus, it clearly provides no authority for deductions not permitted in other contexts by Chapter 1 of the Code. It is a cardinal rule under that chapter that expenses

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See Pet. App. 14a-16a. The purpose of the remand appears to be to allow the Tax Court to consider the argument that petitioner should be allowed to demonstrate a profit motive using a relatively stingy method of allocating fixed overhead expenses to its nonmember activity, under which the gross receipts from that activity exceed the expenses, and then use a relatively generous method of allocation on its tax return to produce losses from that activity that can be deducted against taxable income from other activities.

such as those claimed by petitioner here—costs of goods sold, payroll, depreciation, insurance, and similar items (see, *e.g.*, Pet. App. 11a)—are deductible only if incurred in connection with a trade or business or other profit-motivated activity. See note 4, *supra*; I.R.C. §§ 162, 167; *Commissioner* v. *Groetzinger*, 480 U.S. 23, 35 (1987); *United States* v. *American Bar Endowment*, 477 U.S. 105, 110 n.1 (1986); *United States* v. *Gilmore*, 372 U.S. 39, 44-46 (1963). Thus, petitioner's contention (Pet. 10-14) that Congress intended to confer a special benefit on social clubs by allowing them to take deductions not allowed to any other taxpayer—*i.e.*, "business" deductions even when not incurred in an activity conducted to make a profit—simply has no support in the statute, and it was correctly rejected by the court of appeals (see *North Ridge Country Club* v. *Commissioner*, 877 F.2d 750, 753-755 (9th Cir. 1989)).

The court of appeals was also correct in rejecting petitioner's contention (Pet. 14-17) that it can establish the requisite profit motive if it merely intended that the gross income from its nonmember sales exceed the variable costs of that activity. The established approach for determining profit motivation in assessing whether an activity is a "trade or business" is to measure gross receipts against *all* of the expenses of an activity—both variable and fixed. See generally *The Brook, Inc.* v. *Commissioner*, 799 F.2d 833, 838-840 (2d Cir. 1986). Moreover, the net losses from the nonmember sales activity that petitioner seeks to offset against its investment income result largely, if not entirely, from an allocation of fixed expenses to that nonmember activity. When it is the fixed expenses that are the very expenses claimed as deductions (on the theory that they are

"directly connected" to the nonmember activity (§ 512(a)(3)(A)), it defies reason to suggest that the same expenses can be ignored in making the for-profit determination necessary to support their deductibility.

The court of appeals' holding is further supported by the policy underlying Section 512(a)(3). Congress believed that it would be a "distortion" of the purpose for which social clubs are granted tax-exempt status if they were permitted to use "tax-free dollars" from interest, dividends, or other passive income accruing upon investments to subsidize the recreational interests of their members. H.R. Rep. No. 413, 91st Cong., 1st Sess. Pt. 1, at 48 (1969); S. Rep. No. 552, 91st Cong., 1st Sess. 71 (1969). Thus, social clubs, unlike most tax-exempt organizations, are subject to tax on their investment income (see note 2, *supra*). The net losses claimed by petitioner as offsets against its investment income are generated by fixed overhead that it must incur, irrespective of the nonmember sales, in order to operate its facilities for its members. Because every club has fixed overhead, petitioner's position would make it relatively easy for clubs to defeat the tax on investment income, thereby undermining a basic purpose of the taxation scheme of social clubs. See *North Ridge Country Club* v. *Commissioner*, 877 F.2d at 756.

2. We agree with petitioner (Pet. 7-8) that there exists a direct conflict in the circuits on the question presented. Three courts of appeals have now considered the question on similar facts. The Sixth Circuit has held that a social club's expenses allocable to sales of food and drink to nonmembers are fully deductible under Section 512(a)(3) so long as the sales activity is carried on for "economic gain," even

though it is not intended to produce income in excess of total costs. *Cleveland Athletic Club, Inc.* v. *United States*, 779 F.2d 1160, 1165-1166 (1985). The court stated that such expenses "need not necessarily come within the § 162 trade or business allowance, but rather, the deductions are allowable as ordinary and necessary to the production of income with a basic purpose of economic gain" (*id.* at 1165). The court added (*ibid.*): "We do not believe that the nonmember business activity must generate a tax profit."

The Second Circuit, however, reached the contrary conclusion on similar facts, holding that a social club's expenses from nonmember activity are not deductible to the extent they exceed income from that activity, unless the activity is pursued with a profit motive. *The Brook, Inc.* v. *Commissioner*, *supra*. The court specifically noted that it "disagree[d]" with the Sixth Circuit's decision in *Cleveland Athletic Club*, explaining that "[t]he mere fact that hobbies generate receipts, or 'economic gain,' does not entitle them to § 162 tax treatment," and that "a switch to an 'economic gain' test would give social clubs a tax advantage not enjoyed by other taxpayers" (799 F.2d at 839). The Ninth Circuit in *North Ridge* expressly noted this "conflict of decisions between circuits" (877 F.2d at 753), and it now has also explicitly "reject[ed] *Cleveland Athletic*'s holding that deduction of losses is allowed upon a showing of intent to derive 'economic gain' * * * because no provision in Chapter 1 of the Code allows loss deductions upon such a showing" (*id.* at 754). The court stated instead that it "agree[d] with the *Brook* decision" that a social club must demonstrate a profit motive for its nonmember activity in order to deduct

the expenses under Section 512(a)(3) (*ibid.*). The Ninth Circuit concluded that the profit motive test is not satisfied unless a club intends the gross income from nonmember sales to exceed all the costs, fixed as well as variable, that are allocable to the activity (*id.* at 756). This holding directly conflicts with that of the Sixth Circuit in *Cleveland Athletic Club*, where the club, like petitioner, received gross income from nonmember sales that consistently exceeded the direct expenses, but was less than the total expenses allocated to that activity (see 779 F.2d at 1161).

3. The question presented in this case is of considerable administrative importance. Because many clubs provide food and drink or other goods or services to nonmembers—at prices that do not exceed the total costs allocated to the activity—the practice of claiming losses arising from such activity as offsets against investment income is widespread. That practice substantially undermines the taxation scheme of Section 512(a)(3) by permitting social clubs to use their investment income as a tax-free subsidy for the costs of their member benefits. The volume of litigation on this issue demonstrates the need for resolution of the existing conflict in the circuits. More than 20 cases presenting the issue are currently pending in the lower courts, and the Internal Revenue Service advises that the issue has led to several hundred audits involving approximately $4 million of tax. Thus, resolution of the question presented here is critical to the evenhanded administration of the unrelated business income tax on social clubs.

We note that, because the court of appeals remanded this case for a determination whether petitioner meets the profit-motive test set forth in *North Ridge* (see Pet. App. 3a), the judgment below is interlocutory. The remand order leaves open the possibility that petitioner will prevail on its claim of deductibility on another theory—*i.e.*, if the Tax Court (or the Ninth Circuit on a second appeal) holds that a social club can establish the existence of the requisite profit motive by reference to another, less generous, expense allocation method, while continuing to use the more generous method reflected on its returns to compute the deductions that would be allowable in determining its unrelated business taxable income. While we do not believe that this alternative theory has merit, the remand is a factor that ordinarily militates against the granting of certiorari. See *Brotherhood of Locomotive Firemen* v. *Bangor & A.R.R.*, 389 U.S. 327, 328 (1967); *Hamilton-Brown Shoe Co.* v. *Wolf Bros.*, 240 U.S. 251, 257-258 (1916). Despite this consideration, however, we believe that certiorari is appropriate at this time. The decision below is irreconcilable with that of the Sixth Circuit in *Cleveland Athletic Club* on substantially identical facts, and permitting the conflict to persist until the remand proceedings in this case are concluded would unnecessarily prolong the uncertainty over the correct interpretation of Section 512(a)(3) in the numerous other cases in which this issue has already been raised or can be expected to be raised in the near future. Accordingly, we believe that, notwithstanding the interlocutory nature of the decision below, considerations of judicial economy and of achieving consistent treatment of similarly situated taxpayers make it appropriate to grant certiorari to resolve the conflict in the circuits.[7]

---

[7] We note that the decision in *North Ridge*, which both the Tax Court and the Ninth Circuit treated as the lead

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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DECEMBER 1989

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case on this issue, is not interlocutory. The taxpayer there did not argue that it can prove the existence of a profit motive by using a different allocation for the profit motive determination from that used on its tax return to generate the losses that it seeks to deduct. Thus, the Ninth Circuit's decision in *North Ridge* finally disposed of the taxpayer's claim for the deductibility of its excess expenses, in direct conflict with the result in *Cleveland Athletic Club*, and the court did not remand for further proceedings. Because the taxpayer sought rehearing in the court of appeals in *North Ridge*, its time to petition for certiorari does not expire until December 26, 1989.

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No. 89-530

Supreme Court, U.S.
FILED
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JOSEPH F. SPANIOL, JR.
CLERK

In The

Supreme Court of the United States

October Term, 1989

PORTLAND GOLF CLUB,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE

Respondent.

Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Ninth Court

JOINT APPENDIX

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CERTIORARI GRANTED JANUARY 16, 1990

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UNITED STATES TAX COURT

No. 13436-85

PORTLAND GOLF CLUB

v.

COMMISSIONER OF INTERNAL REVENUE

DOCKET ENTRIES

DATE	PROCEEDINGS
May 20, 1985	Petition filed; fee paid. Served May 21, 1985.
July 8, 1985	Designation of trial at Portland, OR. Served July 9, 1985.
July 8, 1985	Answer by Respondent filed (C/S 7/4/85).
Aug. 20, 1986	Notice of Trial on January 20, 1987, at Portland, Oregon. Served August 20, 1986.
Dec. 8, 1986	Motion by the Parties for continuance.
Dec. 10, 1986	Order that by Dec. [illegible]986 the parties file an agreement to be [illegible]d by the decision in Dkt. No. 20651-82 [illegible]ge Scott) Served Dec. 16, 1986.
Jan. 20, Jan. 21, 1987	Trial at Portland, OR before Judge Scott 1-29 Joint Motion for continuance filed Dec. 8, 1986 – See Order. 1-21 Petr's trial memorandum (served by petr). Resp's trial memorandum (served by resp).

	Stipulation of facts with exhibits attached ORIGINAL BRIEFS DUE: April 14, 1987. REPLY BRIEFS DUE: May 29, 1987. SUBMITTED TO JUDGE SCOTT
Jan. 29, 1987	Ordered that the joint motion for continuance filed on December 8, 1986 is rendered moot. Served Feb. 19, 1987.
Feb. 17, 1987	Transcript for Jan. 21, 1987 received.
Feb. 27, 1987	Transcript for Jan. 29, 1987 received.
Apr. 14, 1987	Brief for Respondent filed. Served April 30, 1987.
Apr. 16, 1987	Motion by Leonard Henzke to file Amicus Curiae for National Club Association (Amicus Curiae Lodged). GRANTED April 17, 1987.
Apr. 17, 1987	Amicus Curiae Statement by Leonard J. Henzke filed. Served April 20, 1987.
Apr. 17, 1987	Petr's Brief filed. (P.M. timely). Served April 20, 1987.
May 29, 1987	Reply Brief for Resp. Served June 5, 1987.
June 2, 1987	Reply Brief for Petr. (P.M. Timely). Served June 5, 1987.
Feb. 24, 1988	Opinion filed, Judge Scott. T.C. Memo. 1988-76. (Decision will be entered for the Petr.) Served Feb. 24, 1988.
Mar. 2, 1988	Decision entered, Judge Scott.

APPELLATE PROCEEDINGS

May 27, 1988	Notice of Appeal to U.S.C.A., 9th Cir., filed by Resp. Served June 3, 1988.
June 3, 1988	Notice of Filing with copy of Notice of Appeal mailed to counsel of record for petr.
June 3, 1988	Notice, to parties, of assembling and date for transmission of record.

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9TH CIRCUIT COURT OF APPEALS

No. 88-7218

PORTLAND GOLF CLUB

v.

COMMISSIONER OF INTERNAL REVENUE

DOCKET ENTRIES

DATE	PROCEEDINGS
6/6/88	DOCKETED CAUSE AND ENTERED APPEARANCES OF COUNSEL. Sent appellant(s) civil appeals docketing statement. (ogm)
6/29/88	FILED CERTIFIED TRANS OF ADMINISTRATIVE RECORD ON APPEAL IN 2 VOLUMES: PLDGS, VOL 1, ORIG ONLY; R/T'S VOL 2, ORIG ONLY. ONE FOLDER OF EXHIBITS. [88-7218] (ch)
7/1/88	Filed William F. Nelson for Appellant CIR Civil Appeals Docketing Statement served on 6/28/88 (to CONFATT) [88-7218] [88-7218] (ch)
7/13/88	Filed order CONFATT (HAH) releasing case from CONFATT and setting briefing schedule appellant's brief, excerpts due 8/22/88 for CIR. [88-7218] (el)
8/4/88	Filed as of 7/29/88, Appellant CIR's motion to hold the case in abeyance pending a decision in 88-7062 [88-7218] served on 7/26/88 [1085654] (PROMO) (el)
8/8/88	Filed as of 8/5/88, Appellee Portland Golf Club's response opposing motion to hold in

	abeyance [1085654-1] served on 8/3/88. (PROMO) [88-7218] (ogm)
8/12/88	Filed order (Deputy Clerk: MLM) denying aplt's motion to hold this appeal in abeyance pending a decision in appeal #88-7062. The clk shall endeavor to calendar appeals #88-7062 & 88-7218 before the same panel. [1085654-1] [88-7218] (el)
8/17/88	10-day Oral extension by phone of time to file Appellant CIR brief [88-7218] appellant(s)' brief due 9/1/88 for CIR (mlm)
8/22/88	Copy of letter received from CIR addressed to aple's counsel, dated 8/19/88 re: confirming 10 day oral extension to file aplt's brief has been granted by the clk's office. [88-7218] (ogm)
9/6/88	Recvd notice of appearance of Robert S. Pomerance Kenneth L. Greene for aplt. [88-7218] (tsp)
9/6/88	Received Appellant CIR's brief in 15 copies of 50 pages, (no excerpts, counsel notified deficient by ltr) Served on 9/1/88 [88-7218] response to brief deficiency notice due 9/20/88 for CIR (tsp)
9/15/88	Received Appellant CIR satisfaction of (minor) brief deficiency re: 5 excerpts of record; accompanied by a motion to file brief and excerpts of record out of time. (PROMP) [88-7218] (ch)
9/16/88	Copy of letter received from CIR re: consenting to the filing of an amicus brief on behalf of the National Club Association as long as brief is filed by the time Appellee's brief is filed. [88-7218] (ch)
9/22/88	Filed motion and deputy clerk order: (Deputy Clerk: AHH) Aplt's motion for leave to file

	the opening brief & excerpts of record out of time is granted. The brief rec'd 9/6/88 & the excerpts of record rec'd 9/15/88 shall be filed. Aple's brief is due 30 days from the date of entry of this order. [1244694-1] [88-7218] (el)
9/22/88	Filed original and 15 copies Appellant CIR opening brief 50 pages, and five excerpts of record in 1 volumes; served on 9/1/88 previously rec'd. [88-7218] (el)
10/26/88	Filed Orig & 15 National Club's Amicus Brief, 33 pages, served on 10/24/88. Accompanied by consenting letters of counsel for filing of the Amicus Brief. [88-7218] (ch)
10/31/88	Filed Original and 15 Appellee's (Portland Golf Club) Briefs, 47 pages, served on 10/24/88. [88-7218] (ogm)
11/10/88	Filed Original and 15 Aplt's (CIR) Reply Briefs, 25 pages, served on 11/8/88. [88-7218] (ogm)
11/14/88	INVENTORIED [88-7218] (mm)
1/11/89	Calendar check performed [88-7218] (rk)
1/12/89	Filed in 88-7062, order (Deputy Clerk: AW) For the convenience of the court, this matter is removed from the San Francisco, 2/14/89 calendar, and shall be rescheduled on the Portland, March, 1989 calendar with CA No. 88-7218. [88-7218] (ch)
1/13/89	Calendar materials being prepared. [88-7218] [88-7218] (aw)
1/18/89	CALENDARED: PO 3/6/89 1:30 p.m. [88-7218] (dd)
2/23/89	Filed in 88-7062 order (Deputy Clerk: AW) The motion of National Club Ass. to participate in oral argument as amicus curiae is denied. [88-7218] (el)

3/14/89	ARGUED AND SUBMITTED TO: CANBY, THOMPSON, LEAVY [88-7218] (bp)
6/1/89	FILED MEMORANDUM OPINION (CANBY, THOMPSON, LEAVY, author, CJJ) REMANDED FILED AND ENTERED JUDGMENT. [88-7218] (ch)
6/1/89	JS-34 disposition reported. Termination on the merits after oral argument (Remanded) [88-7218] (ch)
6/23/89	MANDATE ISSUED. [88-7218] (ch)
8/31/89	Copy of letter received from the US Supreme Court re: an application of ext of time to file a writ of certiorari has been granted to and including 9/29/89. (case file) [88-7218] (ch)
10/10/89	Received notice from Supreme Court: petition for certiorari filed Supreme Court No. 89-530 filed on 9/28/89. [88-7218] (el)
1/23/90	Received notice from Supreme Court, petition for certiorari GRANTED on 1/16/90. (PANEL) (el)

UNITED STATES TAX COURT

PORTLAND GOLF CLUB, Petitioner,	)	Docket No. 13436-85
v.	)	
COMMISSIONER OF INTERNAL REVENUE, Respondent.	)	PETITION

The petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his Notice of Deficiency (AP:PO:90 D:AB:MH) dated February 19, 1985, and as the basis of their case allege as follows:

1. Petitioner is a nonprofit Oregon corporation exempt from tax under Internal Revenue Code § 501 (c)(7) with its principal office at 5900 S.W. Scholls Ferry Road, Portland, Oregon 97225. Petitioner's taxpayer identification number is 93-1256880. The returns for the period here involved were filed with the Office of Internal Revenue Service in Ogden, Utah.

2. The Notice of Deficiency (a copy of which is attached hereto and marked Exhibit A) was mailed to Petitioners on February 19, 1985 and was issued by the office of Internal Revenue Service at Portland, Oregon.

3. The deficiencies as determined by the Commissioner are for unrelated business income tax for fiscal year ending September 30, 1980 in the amount of $1,828.00 of which $1,828.00 is in dispute; and for the fiscal year ending September 30, 1981 in the amount of $3,470.00 of which $3,470.00 is in dispute.

4. The determination of tax set forth in the Notice of Deficiency is based on the following errors:

a. Portland Golf Club engaged in an unrelated business of sale of food and beverage to nonmembers without a profit motive;

b. Food and beverages are sold to nonmembers at prices insufficient to recover the cost of such sales including a reasonable allocation of fixed overhead;

c. The net operating losses for years prior to fiscal year ending September 30, 1980 were the result of sales of food and beverages to nonmembers and such sales were not profit motivated;

d. Unrelated business taxable income should be increased $156,987.00 and $199,098.00 for the taxable years ending September 30, 1980 and September 30, 1981, respectively, because sales in prior years were not profit motivated;

e. Interest income in the amount of $11,752.00 and $21,414.00 for taxable years ending September 30, 1980 and September 31, 1981, respectively, is not exempt function income.

5. The facts upon which petitioner relies, as the basis of its case, are as follows:

a. During the taxable years 1980 and 1981, petitioner, Portland Golf Club, was an Oregon nonprofit corporation exempt from tax under Internal Revenue Code § 501(c)(7).

b. During the years involved, the day-to-day operations of the Club were overseen by a full time

professional manager experienced in the operation of a private club including the operations of the food and beverage service.

c. During the years involved, the operation of the food and beverage portion of the Club was run by a professional food and beverage manager with experience in food preparation, pricing, food service, and other aspects of food and beverage service.

d. The overall operation of the Club is overseen by a Board of Directors of nine members chosen from the membership of the Club.

e. The financial affairs of the Club are overseen by a Finance Committee chosen from members of the Club with particular experience in financial matters.

f. The Board of Directors, Finance Committee, the General Manager and the Food and Beverage Manager were all active during fiscal years ending September 30, 1980 and September 30, 1981 in the operation of the nonmember food and beverage business as well as the exempt functions of the club.

g. Complete books and accounting records are kept by the Club on exempt functions as well as on nonmember food and beverage business. A national firm of certified public accountants is retained to prepare tax returns and provide an annual audited financial statement.

h. The nonmember food and beverage service of Portland Golf Club is operated in a business-like manner with an intent to make a profit.

i. The average price per person charged for nonmembers' food and beverage service is significantly higher than the average price per person charged for members for food and beverage service.

j. During the tax years at issue, and previously, all the direct expenses in total and a portion of the indirect expenses, reasonably apportioned on the basis of gross income, were included as a deduction in determining taxable income or loss for the purpose of filing a return on the unrelated business income tax. The returns showed a taxable loss for those years.

k. The price of nonmember food and beverage is set to make a profit after deducting the direct expenses in total and deducting indirect expenses reasonably apportioned based on the use of the facilities. During the years at issue, petitioner did show a profit from nonmember food and beverage service after deduction of all direct expenses and a reasonable allocation of indirect expenses.

l. Petitioner did not have unrelated business taxable income of $156,987.00 and $199,098.00 for taxable years ending September 30, 1980 and September 30, 1981, respectively.

m. In taxable years ending September 30, 1980 and September 30, 1981, petitioner set aside interest income for future use in pursuing their tax exempt function.

WHEREFORE, petitioner prays that the Court will hear this petition and find:

a. For taxable years ending September 30, 1980 and September 30, 1981, that petitioner was engaged in

sale of food and beverage to nonmembers with an intent to make a profit;

b. That in years prior to tax years ending September 30, 1980, petitioner engaged in sale of food and beverages to nonmembers with an intent to make a profit;

c. That taxpayer did not have unrelated business taxable income of $156,987.00 and $199,098.00 for taxable years ending September 30, 1980 and September 30, 1981, respectively;

d. That the interest income set aside for future use in pursuing exempt purposes is related exempt function income for September 30, 1980 and September 30, 1981; and

e. For such other relief as the Court finds appropriate.

DATED May 16, 1985.

/s/ Allen B. Bush
Allen B. Bush
McEwen, Gisvold, Rankin & Stewart
1408 Standard Plaza
1100 S.W. Sixth Avenue
Portland, OR 97204
Telephone: (503) 226-7321

UNITED STATES TAX COURT

PORTLAND GOLF CLUB, Petitioner, v. COMMISSIONER OF INTERNAL REVENUE, Respondent.	)	Docket No. 13436-85 [Filed July 8, 1985]

ANSWER

THE RESPONDENT, in answer to the petition filed in the above-entitled case, admits and denies as follows:

1, 2, and 3. Admits

4. (a) through (e) Denies the Commissioner erred.

5. (a) Admits.

(b) and (c) Denies for lack of knowledge.

(d) Admits.

(e) and (f) Denies for lack of knowledge.

(g) Denies the first sentence for lack of knowledge; denies the last sentence of lack of knowledge, except admits that a national firm of certified public accountants prepared the tax returns for the fiscal years in dispute.

(h) Denies.

(i) Denies for lack of knowledge.

(j) Denies the first sentence of lack of knowledge; denies the last sentence for lack of knowledge, except admits that for the fiscal years ending September

30, 1980 and September 30, 1981, petitioner's tax returns, Form 990-T, showed a loss with respect to unrelated business taxable income.

(k) and (l) Denies.

(m) Denies for lack of knowledge.

6. Denies generally each and every allegation of the petition not hereinbefore specifically admitted, qualified or denied.

WHEREFORE, it is prayed that the deficiencies determined by the respondent be in all respects approved.

Dated: July 1, 1985

FRED T. GOLDBERG, JR.
Chief Counsel
Internal Revenue Service

By: /s/ Henry R. Snyder
HENRY R. SNYDER
District Counsel

OF COUNSEL:
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UNITED STATES TAX COURT

PORTLAND GOLF CLUB, Petitioner, v. COMMISSIONER OF INTERNAL REVENUE, Respondent.	)	Docket No. 13436-85

STIPULATION OF FACTS

In accordance with Tax Court Rule 91(e), the below signed parties agree to this stipulation of facts pursuant to the general terms of this preamble, *unless specifically expressed otherwise in this stipulation*. All stipulated facts shall be conclusive. All stipulated exhibits shall be considered authentic. All copies shall be considered electronic reproductions of the originals and shall be treated as if originals. Any relevancy objections may be made with respect to all or any part of this stipulation at the time of submission, but all other evidentiary objections are waived unless specifically expressed within this stipulation.

1. The Portland Golf Club (hereinafter "Petitioner") is and at all relevant times was a nonprofit Oregon corporation exempt from tax under Section 501(c)(7) of the Internal Revenue Code of 1954.

2. At the time of filing its petition herein, the Petitioner's principal office was located at 5900 S.W. Scholls Ferry Road, Portland, Oregon.

3. Attached hereto and incorporated herein as Joint Exhibit 1-A is a true and correct copy of the Statutory

Notice of Deficiency, dated February 19, 1985, on which notice this case is based.

4. For the fiscal year ending September 30, 1980, the Petitioner timely filed an Exempt Organization Business Income Tax Return, Form 990-T, a copy of which is attached hereto and incorporated herein as Joint Exhibit 2-B.

5. For the fiscal year ending September 30, 1981, the Petitioner timely filed an Exempt Organization Business Income Tax Return, Form 990-T, a copy of which is attached hereto and incorporated herein as Joint Exhibit 3-C.

6. For the fiscal year ending September 30, 1980, the Petitioner timely filed a Federal tax return, Form 990, a copy of which is attached hereto and incorporated herein as Joint Exhibit 4-D.

7. For the fiscal year ending September 30, 1981, the Petitioner timely filed a Federal tax return, Form 990, a copy of which is attached hereto as Joint Exhibit 5-E.

8. Since 1914, the Petitioner has owned and operated a private golf and country club with a golf course, restaurant and bar, swimming pool, and tennis courts for the benefit of its members, their guests, and nonmembers on a restricted basis.

9. The Petitioner's purpose is, and during the years at issue was, to operate a golf club, restaurant, bar and party facilities, swimming pool, and tennis courts for the benefit of its members and their guests.

10. The Petitioner's exempt activities are the provision of entertainment, dining, and athletic recreation to its members.

11. During the years at issue, the Petitioner also conducted certain nonexempt activities.

12. During the two fiscal years in question, the Petitioner's nonexempt function income was derived from two sources, investments in the form off interest income and the sales of food and beverages to nonmembers.

13. In connection with the nonmember sales of food and beverages, the Petitioner incurred variable expenses such as food and beverage costs, payroll, and other expenses, as well as overhead and fixed expenses.

14. The Petitioner's overhead expenses for the sales of food and beverages to nonmembers consist of items such as administration, taxes, insurance, and depreciation.

15. Petitioner's fixed expenses would be incurred whether the Petitioner served nonmembers or not.

16. Petitioner has consistently deducted an allocable portion of overhead and fixed expenses from nonmember income for purposes of computing tax on its tax return, in accordance with proposed Treas. Reg. 1.512(a)-3(b)(5).

17. Since at least 1975 and up to and including the present, the Petitioner has used an allocation formula based on the ratio that nonmember sales bore to total sales to compute the amount of overhead and fixed expenses allocated to and deducted from the Petitioner's unrelated business income on its tax returns. Such method of allocation is reasonable.

18. For the years at issue, an allocable portion of overhead costs was properly attributable and directly connected to the generation of nonmember income, as set forth on Petitioner's tax returns (Joint Exhibits 2-B and 3-C).

19. Since at least 1975 and up to fiscal year 1984, the Petitioner has incurred losses for tax purposes and has reported losses on its tax returns from the sale of food and beverages to nonmembers.

20. During the fiscal year ending September 30, 1980, the Petitioner received investment income in the form of interest income in the amount of $11,752.00, which it did not report on its tax return, Form 990-T, for said year.

21. Petitioner agrees that for the fiscal year ending September 30, 1980, the $11,752.00 of interest income constitutes taxable investment income. Petitioner claims there is no tax due for fiscal year ending September 30, 1980, as this income merely reduces the net loss for unrelated business income purposes as shown on its tax return. Respondent claims that the Petitioner must pay tax on its interest income for the fiscal year ending September 30, 1980, because the Petitioner did not incur a loss from the sale of food and beverages to nonmembers which can be used to offset such investment income for unrelated business income purposes.

22. During the fiscal year ending September 30, 1981, the Petitioner received investment income in the form of interest income in the amount of $21,414.00, which it did not report on its tax return, Form 990-T, for said year.

23. Petitioner agrees that for the fiscal year ending September 30, 1981, the $21,414.00 of interest income constitutes taxable investment income. Petitioner claims there is no tax due for fiscal year ending September 30, 1981, as this income merely reduces the net loss for unrelated business taxable income purposes as shown on its tax return. Respondent claims that the Petitioner must pay tax on its interest income for the fiscal year ending September 30, 1981, because the Petitioner did not incur a loss from the sale of food and beverages to nonmembers which can be used to offset such investment income for unrelated business income purposes.

24. Many of the Petitioner's expenses are fixed expenses relating to the maintenance and minimum staff requirements of operating its facilities.

25. Petitioner's members are allowed to sponsor guests, friends, and organizations who wish to use the Petitioner's facilities and services for private parties, receptions, or catering. Petitioner's nonmember food and beverage income resulted when these activities did not meet the requirements for member receipts for purposes of I.R.C. § 512 and the regulations and rulings thereunder; i.e., Petitioner's nonmember food and beverage income constitutes unrelated business income.

26. Attached hereto and incorporated herein as Joint Exhibit 6-F is a true and correct copy of a letter dated August 12, 1981 from Petitioner's finance committee to Petitioner's Board of Directors wherein Petitioner's dining room operations are discussed.

27. Attached hereto and incorporated herein as Joint Exhibit 7-G is a true and correct copy of a letter

dated January 25, 1983 from Davison Castles, Director-House Committee, to the Petitioner's Board of Directors which was written in response to a member's questions regarding operation of the Petitioner's dining room and bar.

28. Attached hereto and incorporated herein as Joint Exhibit 8-H is a true and correct copy of a letter dated March 21, 1983 and written by Petitioner's Board of Directors to five of Petitioner's members regarding Petitioner's operations.

29. Attached hereto and incorporated herein as Joint Exhibit 9-I is a true and correct copy of a report, dated September 11, 1982, from Petitioner's finance committee regarding Petitioner's dining room and bar sales.

30. Attached hereto and incorporated herein as Joint Exhibit 10-J is a true and correct copy of the minutes of Petitioner's Finance Committee meeting, dated January 13, 1983.

31. Attached hereto and incorporated herein as Joint Exhibit 11-K is a true and correct copy of a report, dated January 20, 1983, from Petitioner's general manager, Steve Tidrick, to Petitioner's Board of Directors regarding a letter from one of Petitioner's members concerning the operation of Petitioner's dining room and bar.

32. Attached hereto and incorporated herein as Joint Exhibit 12-L is a true and correct copy of Petitioner's Statements of Operation and Members' Equity from Petitioner's audit report for the fiscal years ending September 30, 1980 and September 30, 1981.

33. Attached hereto and incorporated herein as Joint Exhibit 13-M is a true and correct copy of Petitioner's summary of Bar Operations from Petitioner's audit report for the fiscal years ending September 30, 1980 and September 30, 1981.

34. Attached hereto and incorporated herein as Joint Exhibit 14-N is a true and correct copy of Petitioner's summary of Dining Room Operations from Petitioner's audit report for the fiscal years ended September 30, 1980 and September 30, 1981.

35. Attached hereto and incorporated herein as Joint Exhibit 15-0 is a true and correct copy of a summary of Petitioner's Combined Dining Room and Bar Operations for the eleven-month period ended September 30, 1980 and the year ended September 1981. This summary was prepared by one of Petitioner's members in 1985 for purposes of trial preparation and is not a part of Petitioner's regular books and records. This combined summary does not exist for fiscal years other than the two fiscal years at issue herein.

36. Attached hereto and incorporated herein as Joint Exhibit 16-P, page 1-10, are true and correct copies of a summary analysis of Petitioner's dining room operations, both member and nonmember, for the eleven-month period ended September 30, 1980. This summary analysis was prepared by one of Petitioner's members in 1985 for purposes of trial preparation and is not a part of Petitioner's regular books and records. This summary analysis does not exist for fiscal years other than the two fiscal years at issue herein.

37. The summary analysis of Petitioner's dining room operations for the eleven-month period ended September 30, 1980 (Joint Exhibit 16-P, pages 1-10), computes the allocation of overhead and fixed expenses on the basis of actual nonmember use as a percentage of total actual use. Use is stated in square foot hours. This method of allocation (actual use) is different from the method of allocation (gross receipts) Petitioner used in preparing Petitioner's fiscal 1980 tax return (Joint Exhibit 2-B). The actual use method of allocation results in net income from the nonmember food and beverage business of Petitioner. The gross receipts method of allocation, as used by Petitioner on its fiscal 1980 tax return (Joint Exhibit 2-B), results in a net loss from the nonmember food and beverage business of Petitioner.

38. Attached hereto and incorporated herein as Joint Exhibit 17-Q, pages 1-9, are true and correct copies of a summary analysis of Petitioner's dining room operations, both member and nonmember, for the fiscal year ended September 30, 1981. This summary analysis was prepared by one of Petitioner's members in 1985 for purposes of trial preparation and is not a part of Petitioner's regular books and records. This summary analysis does not exist for fiscal years other than the two fiscal years at issue herein.

39. The summary analysis of Petitioner's dining room operations for the fiscal year ended September 30, 1981 (Joint Exhibit 17-Q, pages 1-9), computes the allocation of overhead and fixed expenses on the basis of actual nonmember use as a percentage of total actual use. Use is stated in square foot hours. This method of allocation (actual use) is different from the method of allocation

(gross receipts) Petitioner used in preparing Petitioner's fiscal 1981 tax return (Joint Exhibit 3-C). The actual use method of allocation results in net income from the nonmember food and beverage business of Petitioner. The gross receipts method of allocation, as used by Petitioner on its fiscal 1981 tax return (Joint Exhibit 3-C), results in a net loss from the nonmember food and beverage business of Petitioner.

40. Attached hereto and incorporated herein as Joint Exhibits 18-R, 19-S, 20-T and 21-U are true and correct copies of Petitioner's Exempt Organization Business Income Tax Return, Form 990-T, for the fiscal years ending September 30, 1982, September 30, 1983, September 30, 1984, and September 30, 1985, respectively.

41. The issue in dispute is whether the Petitioner can deduct expenses directly connected to the sale of food and beverages to nonmembers which exceed the gross receipts from such sales.

42. The operation of Petitioner is overseen by a Board of Directors (the "Board") of nine members which meets at least monthly. The Board supervises and reviews the actions of the full-time professional general manager, who controls the operations and implements Board policy on a day-to-day basis.

In addition to the Board, Petitioner has numerous standing committees which assist the Board, including a Finance Committee and House Committee.

WILLIAM F. NELSON
Chief Counsel
Internal Revenue Service

ALLEN B. BUSH
Counsel for Petitioner
McEwen, Gisvold,
Rankin & Stewart
1600 Standard Plaza
1100 SW Sixth Avenue
Portland, OR 97204

Dated:_____
Dated:_____

By _____

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T.C. Memo. 1988-76

UNITED STATES TAX COURT

PORTLAND GOLF CLUB,

Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

Docket No. 13436-85.

Filed February 24, 1988.

Allen B. Bush, for the petitioner.[1]

Gerald W. Douglas, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

SCOTT, *Judge*: Respondent determined deficiencies in petitioner's income taxes for its fiscal years ending September 30, 1980, and September 30, 1981, in the amounts of $1,828 and $3,470, respectively. The issue for decision is whether petitioner, a social club exempt from tax under Section 501(c)(7)[2] may offset against unrelated business taxable income from interest, an amount which represents the excess of its deductions over receipts from sales of food and beverages to nonmembers.

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[1] An amicus curiae statement was filed by Leonard J. Henzke, Jr., as counsel for The National Club Association.

[2] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the years here in issue. Rule references are to the Tax Court Rules of Practice and Procedure.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly:

Petitioner, the Portland Golf Club, is and at all times relevant to the issues involved in this case, has been a nonprofit Oregon corporation exempt from Federal income tax under the provisions of Section 501(c)(7). At the time of filing its petition herein, petitioner's principal office was located in Portland, Oregon. For each of its fiscal years ending September 30, 1980, and September 30, 1981, petitioner filed a Form 990-T, Exempt Organization Business Income Tax Return, and a Form 990, Return of Organization Exempt From Income Tax.[3]

Since 1914, petitioner has owned and operated a private golf and country club with a golf course, restaurant and bar, swimming pool, and tennis courts for the benefit of its members, their guests, and nonmembers on a restricted basis. Petitioner's purpose is, and during the years here in issue was, to operate a golf club, restaurant, bar and party facility, swimming pool, and tennis courts for the benefit of its members and their guests. Petitioner's exempt activities are the provision of entertainment, dining, and athletic recreation to its members.

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[3] The return for petitioner's fiscal year ending September 30, 1980 was a return for a short taxable year of eleven months. Prior to this fiscal year petitioner had a fiscal year ending October 31, but applied for and received authority to change to a fiscal year ending September 30, 1980, resulting in the return for its fiscal year 1980 being for the period November 1, 1979 through September 30, 1980.

During the years in issue petitioner also conducted certain nonexempt activities. During these years petitioner's nonexempt function income was derived from investments which resulted in interest income and from the sales of food and beverages to nonmembers.

Petitioner's members are allowed to sponsor guests, friends, and organizations who wish to use petitioner's facilities and services for private parties, receptions, or catering. Petitioner's nonmember food and beverage income resulted when these activities did not meet the requirements of Section 512 of the Income Tax Regs. and respondent's ruling thereunder. Petitioner's nonmember food and beverage income from these activities constitutes unrelated business taxable income.

Petitioner incurred variable expenses such as food and beverage costs, payroll, and other expenses in connection with its nonmember sales of food and beverages, as well as overhead and other fixed expenses. Petitioner's overhead and other fixed expenses for the sale of food and beverages to nonmembers consisted of items such as administration, taxes, insurance, and depreciation (hereinafter "fixed expenses"). These fixed expenses would be incurred by petitioner whether petitioner served nonmembers or not. On its returns' Forms 990-T, petitioner has consistently deducted an allocable portion of overhead and fixed expenses from nonmember income in accordance with Prop. Income Tax Regs. Section 1.512(a)-(3)(b)(5).[4] Since 1975, through and including the years here in issue, petitioner has used an allocation

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[4] This proposed regulation was withdrawn as of January 23, 1987 by notice published on January 26, 1987 in the Federal Register. 52 Fed. Reg. 2724-2725.

formula based on the ratio that nonmember sales bore to total sales to compute the amount of overhead and fixed expenses allocated to and deducted from petitioner's unrelated business taxable income on its returns. Such method of allocation is reasonable.[5] For the years at issue an allocable portion of petitioner's overhead costs was properly attributable and directly connected to the generation of nonmember income. Using this method of reporting, petitioner has, since 1975 and up to its fiscal year 1984, incurred losses for tax purposes from the sale of food and beverages to nonmembers and has reported these losses on its Form 990-T returns. Many of petitioner's expenses are fixed expenses relating to maintenance and minimum staff requirements of operating its facilities.

Petitioner's prices for the sales of food and beverages to nonmembers were in excess of the prices of food and beverages served to members. Petitioner, in determining the prices to be charged for food and beverages to be served to nonmembers attempted to arrive at amounts which would result in the amount received from these sales being in excess of all variable costs directly related to such sales. The variable costs considered were items such as the food costs, supplies, beverage costs and labor costs. Petitioner priced sales of food and beverages to nonmembers so that the cost of food was about 30 percent to 33 percent of the selling price of the meal. Had petitioner chosen to allocate fixed overhead for the years here in issue based on actual use of facilities, it would have had net taxable income for income tax purposes from the sale of food and beverages to nonmembers as shown by the following schedule:

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[5] The parties stipulated to this fact in the exact language used in this opinion.

	11 Months Ending 9/30/80			Year Ending 9/30/81		
	Dining Room	Bar	Total	Dining Room	Bar	Total
Sales	$68,122	$16,300	$84,422	$85,134	$21,413	$106,547
Variable expenses:						
Food & Liquor	27,249	5,183	32,432	34,054	6,617	40,671
Labor & Other Related Costs	14,540	5,281	19,821	16,868	7,259	24,127
Other	8,362	1,206	9,568	11,853	1,756	13,609
	$50,151	$11,670	$61,821	$62,775	$15,632	$78,407
Excess of Sales over Variable Expenses	$17,971	$ 4,630	$22,601	$22,359	$ 5,781	$28,140
Fixed Expenses	3,153	0 *	3,153	4,666	0 *	4,666
Profit	$14,818	$ 4,630	$19,448	$17,693	$ 5,781	$23,474

* Fixed expenses are included under Dining Room.

From its fiscal year 1975 through its fiscal year 1984, the preparation of petitioner's Form 990-T, Exempt Organization Business Income Tax Returns, in accordance with the Prop. Income Tax Regs., Section 1.512(a)-3(b)(5), resulted in losses for tax purposes from the sale of food and beverages to nonmembers.

Petitioner's activities were run in a business-like manner and it kept complete and accurate books and records of its activities. Petitioner's operations were overseen by a board of directors (board) of nine members which met at least monthly. The board supervises and reviews the actions of the full-time, professional, general manager, who controls the operations and implements board policy on a day-to-day basis. During the years at issue, petitioner's board was made up of business people and professionals from various backgrounds. Petitioner's board, finance committee, and staff, in a number of instances, discussed and dealt with the problems relating to petitioner's food and beverage sales, and in these discussions, considered these food and beverage operations as important to petitioner's overall financial operations. From time to time the board discussed the nonmember food and beverage sales of petitioner. Petitioner had a standing finance committee which met monthly to review financial statements, conduct studies concerning the financial aspect of petitioner's operations, and generally to discuss the implementing of board policy in the area of financial matters. Under date of August 12, 1981, the finance committee addressed a memorandum to the board attaching an analysis of the dining room operations of petitioner. In the analysis, the committee pointed out that whereas ordinary meals served to members at the

club resulted in a loss, amounts received from private party functions including nonmember functions, generated higher than average sales and resulted in a profit. One of the conclusions in this report was that since nonmembers spend more than members per meal, the club should increase the number of nonmember meals served each month, and should encourage club members to bring in individuals and other nonmembers for lunches, dinners and special functions. Subsequently, various other studies were made of the food operations which considered ways of encouraging private parties of members and nonmember activities.

During the years here in issue the manager of petitioner was an individual with a bachelor of science degree in hotel and restaurant administration and a bachelor of science degree in recreation administration. This manager had previous employment with hotels and private clubs. The manager was a certified club manager and had served as an officer of the local chapter of Club Managers' Association of America, as well as a state director of Restaurants of Oregon Association. The price of food and beverages at nonmember activities was set by the board and the club management at an amount intended to result in a profit to the club over the direct cost associated with the activity. In addition, these activities were intended to attract additional members to the club, resulting in additional income from initiation fees, and to sharpen the skills of the chef and his staff.

During its fiscal year ended September 30, 1980, petitioner received investment income in the form of interest in the amount of $11,752. This interest constituted unrelated business taxable income to petitioner. During its

fiscal year ended September 30, 1981, petitioner received investment income in the form of interest in the amount of $21,414, which also constituted unrelated business taxable income to petitioner. On its Forms 990-T filed for its fiscal years ended September 30, 1980 and September 30, 1981, petitioner showed a loss on food and beverage sales of $28,433 and $69,608, respectively, computed on the basis of deducting an allocable portion of overhead and fixed expenses from nonmember income based on the percentage of nonmember sales to total sales in accordance with proposed Income Tax Regulations, Section 1.512(a)-3(b)(5). Respondent in his notice of deficiency to petitioner included in petitioner's income the interest income received in its fiscal years 1980 and 1981 and disallowed the deductions claimed in those years for losses on food and beverage sales to nonmembers, as well as the loss carryovers which petitioner claimed based on losses on nonmember food and beverage sales for prior years. Respondent explained the disallowance of the food and beverage losses by stating that—

> food and beverages are being sold to nonmembers at prices insufficient to cover the cost of such sales. These sales have consistently over a number of years only resulted in losses, consequently it is determined that such sales are not profit-motivated and any net loss cannot be deducted in computing unrelated business taxable income.

A similar explanation with respect to nonmember sales in prior years was given for the disallowance of the loss carryovers.

OPINION

Respondent's position in this case is that petitioner's losses, properly computed under his proposed Regulations, from the sale of food and beverages to nonmembers are not deductible by petitioner in determining its unrelated business taxable income since the expenses causing these losses were not incurred in a trade or business carried on for profit and, therefore, are not deductible as business expenses under Section 162. Respondent takes the position that the fact that petitioner shows a profit from the sale of food and beverages to nonmembers when the income from that activity is computed by determining deductible variable expenses on a percentage of use of facilities basis, is immaterial to determining whether it had a profit motive in conducting that activity, since petitioner actually reported the losses from this activity by allocating the fixed expenses in another acceptable manner.

It is further respondent's position that the primary motivation of petitioner's nonmember business activities was to provide a financial benefit to its members in that the revenues from the sales of food and beverages to nonmembers reduce the need for increasing members' assessments or increasing members' prices. Respondent concludes that since petitioner had no objective expectation of recovering all directly allocable expenses of its nonmember sales, it did not engage in the selling of food and beverages to nonmembers with a profit motive. Respondent contends that absent a profit motive, petitioner's nonmember sales of food and beverages do not constitute a trade or business and therefore the expenses

connected with this activity are not deductible by petitioner under Section 162. Respondent argues that for this reason it is improper to use the losses reported by petitioner from its food and beverage sales to nonmembers to reduce its unrelated business taxable income from interest in each of the years here in issue.

Petitioner, in answer to respondent's contentions, argues that since Section 512(a)(3)(A) defines certain income of nonprofit social clubs as "unrelated business taxable income" expenses directly connected with the production of that business related income are by definition expenses incurred in a trade or business which meets the requirements of Section 162. Petitioner argues that for this reason the profit motivation test is not applicable in determining whether an activity conducted by a nonprofit social club is a trade or business. Petitioner further argues that in any event it did intend to make a profit and did make a profit on its nonmember food and beverage sales. Petitioner concludes that it therefore properly aggregated income and expenses from all nonexempt sources to arrive at its unrelated business taxable income.

Petitioner, a tax exempt social club, under the provisions of Section 501(c)(7) is generally exempt from income tax under Section 501(a). However, as a nonexempt social club, petitioner is subject to the tax imposed by Section 511 on unrelated business taxable income pursuant to Section 501(b). The term unrelated business

taxable income is defined in Section 512(a)(1).[6] Section 512(a)(3) sets forth specific provisions with respect to the unrelated business taxable income of social clubs.[7] Section 512(a)(3)(B)[8] defines exempt function income as the

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[6] Sec. 512(a)(1) provides as follows:

(1) General Rule. – Except as otherwise provided in this subsection, the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (as defined in Section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

[7] Sec. 512(a)(3)(A) provides as follows:

(A) General Rule. – In the case of an organization described in Section 501(c)(7) or (9), the term "unrelated business taxable income" means the gross income (excluding any exempt function income), less the deductions allowed by this chapter which are directly connected with the production of the gross income (excluding exempt function income), both computed with the modifications provided in paragraphs (6), (10), (11), and (12) of subsection (b). * * *

[8] Sec. 512(a)(3)(B) provides as follows:

(B) Exempt Function Income. – For purposes of subparagraph (A), the term "exempt function income" means the gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members or their dependents or guests goods, facilities, or services in furtherance of the purposes constituting the basis for the exemption of the organization to which such income is paid. Such term also means all income (other than an amount equal to the gross income derived from any unrelated trade or business regularly carried on by such organization computed as if the organization were subject to paragraph (1), which is set aside * * * .

gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members or their dependents or guests goods, facilities, or services in furtherance of the purposes constituting the basis for the exemption of the organization to which such income is paid.

It is clear therefore, and neither party argues to the contrary, that amounts paid to petitioner by its members whether by assessment, dues, fees, or for meals, are exempt income but that all other income received by petitioner is unrelated business taxable income. Its income from sales to nonmembers is by definition unrelated business taxable income. Petitioner argues that because of this definition and the legislative history of Section 512, it follows that it is not necessary that an activity by a social club be a trade or business in the ordinary sense of that term as used in Section 162 to constitute an unrelated taxable income activity of such club. Petitioner argues that respondent in taking a position to the contrary ignores the definition of business taxable income and business activity contained in Section 512. Respondent argues that petitioner is incorrect in its interpretation of the statute, since the statute specifically provides that the unrelated business taxable income means the gross income less deductions "allowed by this chapter" which are directly connected with the production of gross income. It is respondent's position that deductions "allowed by this chapter" mean deductions under Section 162 and that in order for items to be deductible under Section 162 they must be incurred in connection with a trade or business. Respondent in support of his position cites the case of *Brook, Inc. v. Commissioner*, 799 F.2d 833 (2d Cir. 1986),

which affirmed in result a Memorandum Opinion of this Court. Respondent in his brief recognizes that the decision of the Second Circuit in *Brook, Inc. v. Commissioner, supra*, might be considered contrary to the decision in *Cleveland Athletic Club, Inc. v. United States*, 779 F.2d 1160 (6th Cir. 1985). Recently, in a Court-reviewed opinion, we discussed the holding of the Court in *Brook, Inc. v. Commissioner, supra*, as well as the holding in *Cleveland Athletic Club, Inc. v. United States, supra*. See *North Ridge Country Club v. Commissioner*, 89 T.C. 563 (1987). In the *North Ridge Country Club* case we concluded that it was unnecessary for us to choose between the positions with respect to Section 512(a)(3) taken in *Brook, Inc. v. Commissioner, supra* and *Cleveland Athletic Club, Inc. v. United States, supra*, since we had found in the case there under consideration that the taxpayer's sales of food and beverages to nonmembers were made with a profit motive.

The situation here with respect to food and beverage sales is indistinguishable from the situation involved in *North Ridge Country Club v. Commissioner, supra*.[9]

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[9] In fact, after the filing of the opinion in *North Ridge Country Club v. Commissioner*, 89 T.C. 563 (1987), petitioner forwarded a copy of the opinion to the Court with a letter that stated in part as follows:

> Enclosed please find a copy of the recent Tax Court decision in *North Ridge Country Club v. CIR*. As you recall, this case involved similar issues as the above-referenced case.
>
> * * *

(Continued on following page)

Petitioner had a profit from its sales of food and beverages to nonmembers if only the direct costs incurred in connection with those sales are deducted from the receipts from such sales and also had a profit if a further deduction is made for fixed expenses on a use of space allocation. The fixed costs which petitioner deducted to arrive at the loss for tax purposes were costs which the club would have to pay whether or not it had sales to nonmembers, allocated on a basis of total nonmember sales as compared to total member sales.[10]

(Continued from previous page)

At present, I do not think additional argument need be made in the Portland Golf Club case other than to say that we concur with the decision in *North Ridge Country Club* and its rationale.

If, upon reflection, I think further argument would clarify any issue of our case in light of the *North Ridge Country Club* case, I would petition the court for leave to file a supplemental brief.

A copy of petitioner's letter to the Court with its attachment was sent to respondent's counsel but respondent's counsel did not request that he be permitted to file any further brief in an attempt to distinguish the *North Ridge Country Club* case from the instant case.

[10] Since food and beverages sold to nonmembers were sold at prices in excess of food and beverages sold to members this result is not surprising but rather might well be anticipated. Respondent has stipulated in this case, however, that this method of allocation is proper and acceptable in computing petitioner's unrelated business taxable income from food and beverage sales. We therefore have not considered whether the facts in this case support such an expense allocation in arriving at income or loss from nonmember food and beverage sales for income tax purposes.

We held on the facts in *North Ridge Country Club v. Commissioner, supra*, that the taxpayer did have a profit motive in its nonmember food and beverage sales activity. Clearly in this case, petitioner likewise had a profit motive in its nonmember food and beverage sales activity. It did intend to make a profit, and did make a profit between the amount received from sales to nonmembers and the costs related to those sales which would not have been incurred absent those sales.[11] It is only by allocating a part of the expenses which petitioner would have in all events incurred on a sales ratio basis, permitted by respondent, to the sales to nonmembers, that a loss results.

In *North Ridge Country Club v. Commissioner, supra*, we stated with respect to respondent's argument that profit motive on any allocation of fixed expenses other than the allocation method used on the taxpayer's returns was immaterial in determining the taxpayer's profit motive as follows (89 T.C. at 572-573):

> Respondent contends, however, that we must look to *taxable* income in order to determine whether there is profit motivation. He argues that since petitioner is allowed to deduct an allocable portion of the fixed or indirect costs

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[11] We have not ignored respondent's statement that this is not a fact for petitioner's fiscal year 1981. However respondent bases this statement on a schedule in petitioner's Form 990-T for its fiscal year 1981 which did not properly segregate costs which would not have been incurred absent the nonmember sales from other costs. The evidence clearly shows that petitioner had income from nonmember sales based on deducting from such sales only expenses which would not have been incurred absent such sales and respondent does not seriously contend to the contrary.

in arriving at unrelated business taxable income, petitioner should also be required to take these costs into consideration in regard to determining profit motivation. Petitioner is, in effect, says respondent, having it both ways. While there is a certain pleasing symmetry to respondent's argument, we do not believe it to be determinative of the question before us.[18] The record as a whole makes it apparent that petitioner was seeking profit from these activities and we so hold.

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[18] We note that it is respondent who allows the deduction of the indirect fixed costs against the nonexempt income; costs which otherwise would be borne in their entirety by the club membership.

Respondent argues that to permit petitioner to offset the loss from its nonmember sales of food and beverages computed in accordance with respondent's proposed regulations against other unrelated business taxable income, in effect, permits petitioner to use these nonmember activities to cause its dues, assessments, and meal costs to its members to be less. It is respondent's position that it was to avoid such a result that Congress enacted the special provision with respect to unrelated business taxable income for social clubs exempt from tax under Section 501(c)(7). This same argument was made by respondent in *North Ridge Country Club v. Commissioner, supra,* and was rejected. * * * Likewise respondent's reliance on *Ye Mystic Krewe of Gasparilla v. Commissioner,* 80 T.C. 755 (1983), is misplaced. The facts in that case differ substantially from the facts in the instant case. In that case as we explained in *North Ridge Country Club v. Commissioner, supra,* we held that the taxpayer could not offset

its expenses of staging a mock invasion of Tampa and a parade, its exempt activities, against concession income which it received, since the expenses of staging an invasion and parade were not directly connected with the production of the concession income within the meaning of Section 512(a)(3)(A). We pointed out that the taxpayer in *Ye Mystic Krewe of Gasparilla v. Commissioner, supra,* received only the net income from the concessions and logbook sales so that its expenses with respect to these sales had already been deducted from the gross proceeds and that, therefore, the gross proceeds constituted unrelated business taxable income.

In this case, as in the *North Ridge Country Club* case, petitioner's activities with respect to sales of food and beverages to nonmembers results in a loss when the costs related thereto including a pro rata part of fixed expenses (computed by a method respondent agrees is acceptable) are considered.

In our view there is no distinction between the instant case and the situation we considered in *North Ridge Country Club v. Commissioner, supra,* a Court-reviewed case. Based on our reasoning and holding in that case, and for the reasons set forth herein, we hold that petitioner is entitled to offset its unrelated business taxable income from interest by its loss from its nonmember food and beverage sales computed by allocating a portion of its fixed expenses to the nonmember food and beverage

sales activity in a manner which respondent agrees is acceptable.[12]

Decision will be entered for the petitioner.

[12] Respondent does not argue in this case as he did in *North Ridge Country Club v. Commissioner*, 89 T.C. 563 (1987), that petitioner is not entitled to offset a loss from one of its unrelated business taxable income activities against a profit from another such activity. Here respondent only argues that the loss from petitioner's nonmember food and beverage sales should not be offset against the interest unrelated business taxable income because the nonmember food and beverage sales activity was not engaged in with a profit motive. Since we have concluded that the activity was engaged in with a profit motive, we do not need to consider further, based on respondent's argument, whether the excess of expenses over income from the nonmember sales of food and beverages may be deducted from the interest income received by petitioner.

UNITED STATES TAX COURT

PORTLAND GOLF CLUB Petitioner-Appellee	)	
v.	)	Docket No.
COMMISSIONER OF INTERNAL REVENUE Respondent-Appellant	)	13436-85

NOTICE OF APPEAL

Notice is hereby given that the Commissioner of Internal Revenue appeals to the United States Court of Appeals for the Ninth Circuit from the decision of this court entered on the above-captioned proceeding on the second day of March, 1988.

Petitioner's principal place of activity and business at the time it filed its petition was in Portland, Oregon. Accordingly, appellate venue is properly placed with the United States Court of Appeals for the Ninth Circuit.

Dated: 27 May, 1988

/s/ William S. Rose, Jr.
WILLIAM S. ROSE, JR.
Assistant Attorney General
Department of Justice

/s/ William F. Nelson
WILLIAM F. NELSON
Chief Counsel
Internal Revenue Service

Filed June 1, 1989
Cathy A. Catterson, Clerk
U.S. Court of Appeals

NOT FOR PUBLICATION

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

PORTLAND GOLF CLUB,
Petitioner-Appellee,

v.

COMMISSIONER INTERNAL REVENUE SERVICE,
Respondent-Appellant.

No. 88-7218
Tax Ct. No. 13436-85
MEMORANDUM*

Appeal from a Decision of the
Tax Court of the United States

Argued and Submitted March 6, 1989
Portland, Oregon

Before: CANBY, THOMPSON, and LEAVY, Circuit Judges.

In *North Ridge Country Club v. C.I.R.*, we recently held that a social club's losses from a non-member activity are not deductible under I.R.C. § 512(a) unless that activity was entered into with the intent of producing gains in excess of direct costs (costs related to the non-member activity) and indirect costs (overhead and other fixed expenses). In so doing, we reversed the tax court's

*This disposition is not appropriate for publication and may not be cited to or by the courts of this circuit except as provided by Ninth Circuit Rule 36-3.

decision, since we concluded the court applied the wrong legal standards for profit under Section 512(a).

The tax court decided this case by applying the same standards we rejected in *North Ridge*. Because Portland Golf Club could have reported gains in excess of direct and indirect costs, but did not do so, relying on a method of allocation stipulated to be reasonable by the Commissioner, we REMAND this case to the tax court for a determination of whether Portland Golf Club engaged in its non-member activities with the intent required under *North Ridge* to deduct its losses from those activities.

REMANDED.

UNITED STATES COURT OF APPEALS
For the Ninth Circuit

PORTLAND GOLF CLUB, Petitioner-Appellee,	)	CA No. 88-7218 Tax Ct No. 13436-85
v.	)	
COMMISSIONER INTERNAL REVENUE SERVICE Respondent-Appellant	)	**JUDGMENT** MANDATE ISSUED Jun 23, 1989

Upon Petition to Review a Decision of the Tax Court of the United States, ___

This Cause came on to be heard on the Transcript of the Record from the Tax Court of the United States, ___

___and was duly submitted.

On Consideration Whereof, it is now here ordered and adjudged by this Court, that the ___ Decision of the said Tax Court of the United States in this Cause be, and hereby is *REMENDED*

Filed and entered *June 1, 1989*

SUPREME COURT OF THE UNITED STATES
OFFICE OF THE CLERK
WASHINGTON, D. C. 20543

January 16, 1990

Mr. Leonard J. Henzke
Lehrfeld, Canter & Henzke
Ste. 403, 1101 CT Avenue, N.W.
Washington, DC 20036

Re: Portland Golf Club
v. Commissioner of Internal Revenue
No. 89-530

Dear Mr. Henzke:

The Court today entered the following order in the above entitled case:

The petition for a writ of certiorari is granted.

Very truly yours,
/s/ Joseph F. Spaniol, Jr.
Joseph F. Spaniol, Jr., Clerk

Internal Revenue Service
Regional Commissioner

Department of the Treasury
AP:PO:90D:AB:MH

Date: FEB 19 1985

93-0256880

Tax Year Ended and Deficiency:

September 30, 1980	$1,828.00
September 30, 1981	$3,470.00

Portland Golf Club
5900 S. W. Scholls Ferry Rd.
Portland, Oregon 97225

Person to Contact:
Arnold L. Barritt
Contact Telephone Number:
(503) 294-5028

48

Gentlemen:

We have determined that there is a deficiency (increase) in your income tax as shown above. This letter is a NOTICE OF DEFICIENCY sent to you as required by law. The enclosed statement shows how we figured the deficiency.

If you want to contest this determination in court before making any payment, you have 90 days from the above mailing date of this letter (150 days if addressed to you outside of the United States) to file a petition with the United States Tax Court for a redetermination of the amount of your tax. The petition should be filed with the United States Tax Court, 400 Second Street NW., Washington, D.C. 20217, and the copy of this letter should be attached to the petition. The time in which you must file a petition with the Court (90 or 150 days as the case may be) is fixed by law and the Court cannot consider your case if your petition is filed late. If this letter is addressed to both a husband and wife, and both want to petition the Tax Court, both must sign the petition or each must file a separate, signed petition. You can get a copy of the rules for filing a petition by writing to the Clerk of the United States Tax Court, at the address shown in this paragraph.

If you decide not to file a petition with the Tax Court, we would appreciate it if you would sign and return the enclosed waiver form. This will permit us to charge your account quickly and will limit the accumulation of interest. The enclosed addressed envelope is for your convenience. If you decide not to sign and return the waiver and you do not timely petition the Tax Court, the law requires us to bill you after 90 days from the above mailing date of this letter (150 days if this letter is addressed to you outside the United States).

If you have any questions, please contact the person whose name and telephone number are shown above.

Sincerely yours,

Roscoe L. Egger, Jr.
Commissioner
By
Jackson S. Kohagura
Associate Chief
Appeals Office

EXHIBIT A

Enclosures:
Copy of this letter
Statement
Waiver
Envelope
cc: Allen B. Bush
1500 SW First, Suite 800, Portland, OR 97201-5856

EXHIBIT NO. _____

Form 4089 (Rev. May 1982)	Department of the Treasury – Internal Revenue Service **Notice of Deficiency-Waiver**	Symbols AP:PO:90D:AB:MH

Name, SSN or EIN, and Address of Taxpayer(s)

Portland Golf Club
5900 S. W. Scholls Ferry Road
Portland, Oregon 97225

EIN: 93-0256880

Kind of Tax	[X] Copy to Authorized Representative	
Income	Allen B. Bush, Attorney at Law 729 S. W. Alder, Suite 600 Portland, Oregon 97205	

Taxable Year Ended	Deficiency	
	Increase in Tax	Penalties
September 30, 1980	$1,828.00	
September 30, 1981	$3,470.00	

See the attached explanation for the above deficiencies

I consent to the immediate assessment and collection of the deficiencies (increase in tax and penalties) shown above, plus any interest provided by law.

Your Signature	▶	(Date signed) .....
Spouse's Signature, If A Joint Return Was Filed	▶	(Date signed) .....
Taxpayer's Representative Sign Here	▶	(Date signed) .....
Corporate Name:	Portland Golf Club	
Corporate Officers Sign Here	▶ ..... (Signature) (Title)	(Date signed) .....
	▶ ..... (Signature) (Title)	(Date signed) .....

Note:

If you consent to the assessment of the amounts shown in this waiver, please sign and return it in order to limit the accumulation of interest and expedite our bill to you. Your consent will not prevent you from filing a claim for refund (after you have paid the tax) if you later believe you are entitled to a refund. It will not prevent us from later determining, if necessary, that you owe additional tax; nor will it extend the time provided by law for either action.

If you later file a claim and the Internal Revenue Service disallows it, you may file suit for refund in a district court or in the United States Court of Claims, but you may not file a petition with the United States Tax Court.

Who Must Sign

If this waiver is for any year(s) for which you filed a joint return, both you and your spouse must sign the original and duplicate of this form. Sign your name exactly as it appears on the return. If you are acting under power of attorney for your spouse, you may sign as agent for him or her.

For an agent or attorney acting under a power of attorney, a power of attorney must be sent with this form if not previously filed.

For a person acting in a fiduciary capacity (executor, administrator, trustee), file Form 56, Notice Concerning Fiduciary Relationship, with this form if not previously filed.

For a corporation, enter the name of the corporation followed by the signature and title of the officer(s) authorized to sign.

If you agree, please sign one copy and return it; keep the other copy for your records.

Form 5278 (Rev. May 1982) | Department of the Treasury – Internal Revenue Service

Statement — Income Tax Changes

Return Form No. 990-T | Schedule No. 1

Name(s) of Taxpayer(s)

Portland Golf Club

☒ Notice of Deficiency ☐ Other (specify)
☐ Settlement Computation

	Tax Years Ended		
1. Adjustments to income	9/30/80	9/30/81	
a. Loss on Food and Beverage Sales	28,433.00	69,608.00	
b. Net Operating Loss Deduction	156,987.00	199,098.00	
c. Interest Income	11,752.00	21,414.00	
d. Specific Deduction	(1,000.00)	(1,000.00)	
e.			
f.			
g.			
2. Total adjustments	196,172.00	289,120.00	
3. a. ☒ Taxable income ☐ Adjusted gross income ☐ Tax table income b. As shown in: ☐ Preliminary letter dated ____ ☐ Notice of deficiency dated ____ ☒ Return as filed	(185,420.00)	(268,706.00)	
4. ☒ Taxable income as revised ☐ Adjusted gross income as revised ☐ Tax table income as revised	10,752.00	20,414.00	
5. Tax from ☐ Tables ☐ Schedule TC ☐ Tax rate schedules	1,828.00	3,470.00	
6. Alternative tax if applicable (from page ____)			
7. Corrected tax liability (lesser of line 5 or 6)	1,828.00	3,470.00	
8. Less credits (specify) a.			
b.			
c.			
9. Balance (line 7 less amounts on lines 8a through 8c)	1,828.00	3,470.00	
10. Plus a. Tax from recomputing prior year investment credit			
b. Self-employment tax			
c.			
11. Total corrected income tax liability (line 9 plus amounts on lines 10a through 10c)	1,828.00	3,470.00	
12. Total tax shown on return or as previously adjusted	0	0	
13. Increase or (decrease) in tax (difference between lines 11 and 12)	1,828.00	3,470.00	
14. Additions to the tax (listed below)			

* U.S. GOVERNMENT PRINTING OFFICE: 1982-381-543/5235

1(a) During the taxable years ending September 30, 1980 and September 30, 1981 sales of food and beverages to nonmembers resulted in losses of $28,433.00 and $69,608.00, respectively. Food and beverages are being sold to nonmembers at prices insufficient to recover the costs of such sales. These sales have consistently, over a number of years, only resulted in losses. Consequently, it is determined that such sales are not profit motivated and any net loss cannot be deducted in computing unrelated business taxable income. Accordingly, unrelated business taxable income is increased $28,433.00 and $69,608.00 for the taxable years ending September 30, 1980 and September 30, 1981, respectively.

1(b) Food and beverages are being sold to nonmembers at prices insufficient to recover the costs of such sales. These sales have consistently, over a number of years, only resulted in losses. Net operating loss carryovers of $156,987.00 and $199,098.00 were claimed as deductions for the taxable years ending September 30, 1980 and September 30, 1981, respectively. It is determined that such sales are not profit motivated and any net loss, including any net operating loss carryover, cannot be deducted in computing unrelated business taxable income. Accordingly, unrelated business taxable income is increased $156,987.00 and $199,098.00 for the taxable years ending September 30, 1980 and September 30, 1981, respectively.

1(c) It is determined that interest income in the amounts of $11,752.00 and $21,414.00 was received for the taxable years ending September 30, 1980 and September 30, 1981, respectively. Interest income is not exempt function income and is included in computing unrelated business taxable income. Accordingly, unrelated business taxable income is increased $11,752.00 and $21,414.00 for the taxable years ending September 30, 1980 and September 30, 1981, respectively.

1(d) The specific deduction of $1,000.00 provided by Section 512(b)(12) of the Internal Revenue Code is being allowed. Accordingly, unrelated business taxable income is decreased $1,000.00 for the taxable years ending September 30, 1980 and September 30, 1981, respectively.

[f 265] 125 1-80

Form **990-T**

Department of the Treasury
Internal Revenue Service

Exempt Organization Business Income Tax Return

(Under Section 511 of the Internal Revenue Code)

For the calendar year of 1979 or fiscal year beginning NOVEMBER 1, 1979, and ending SEPTEMBER 30, 1980

1283

1979

Name of organization: PORTLAND GOLF CLUB 29347200 10001

Address (number and street): 5900 S.W. Scholls Ferry Road

City or town, State, and ZIP code: Portland, Oregon 97225

A Employer identification number (employees' trust see instruction K): 93 0256880

B Enter unrelated business activity codes from page 10 of instructions

C Check box if address changed ▶ ☐

D Exempt under section ▶ 501 (C) (7)

E Check applicable box ▶ ☐ Corporation ☐ Trust

F Group exemption number (see Specific Instructions) ▶

Complete only page 1 and sign return on page 4 if unrelated trade or business gross income is $10,000 or less.
Complete all applicable parts of the form (except lines 1 thru 5) if unrelated trade or business gross income is over $10,000.

Unrelated Business Taxable Income Computation—When Unrelated Trade or Business Gross Income is $10,000 or Less

1	Unrelated trade or business gross income. (State sources .....)	
2	Minus deductions	
3	Unrelated business taxable income before specific deduction	
4	Minus specific deduction (see General Instruction O(4))	
5	Unrelated business taxable income	

Tax Computation

Organizations Taxable as Corporations (See General Instruction B(1))

6	Unrelated business taxable income (line 5 above, or line 33, page 2)	(185,420)
7	Enter the smaller of line 6 or $25,000. (Members of a controlled group, see page 8 of instructions.)	
8	Line 6 minus line 7	
9	Enter the smaller of line 8 or $25,000. (Members of a controlled group, see page 8 of instructions.)	
10	Line 8 minus line 9	
11	Enter the smaller of line 10 or $25,000. (Members of a controlled group, see page 8 of instructions.)	
12	Line 10 minus line 11	
13	Enter the smaller of line 12 or $25,000. (Members of a controlled group, see page 8 of instructions.)	
14	Line 12 minus line 13	
15	17% of line 7	
16	20% of line 9	
17	30% of line 11	
18	40% of line 13	
19	46% of line 14	
20	Income tax (add lines 15 through 19). Check here ☐ if alternative tax from Schedule D is used	NONE

Trusts Taxable at Trust Rates (See General Instruction B(2)) (Section 401(a) Trust Check Here ▶ ☐)

21	Enter here and on line 22 the smaller of— The tax on amount shown on line 5 above or line 33, page 2 (from Tax Rate Schedule on page 9 of instructions)	NONE
22	Income tax (from line 20 or 21, whichever is applicable)	NONE

Total Income Tax

23	(a) Foreign tax credit (corporations attach Form 1118, trusts attach Form 1116)		
	(b) Investment credit (attach Form 3468 and/or Schedule B (Form 3468))		
	(c) Work incentive (WIN) credit (attach Form 4874)		
24	Total (add lines 23(a), (b), and (c))		
25	Line 22 minus line 24		NONE
26	Tax from recomputing a prior year investment credit (attach Form 4255)		
27	Tax from recomputing a prior year WIN credit (see page 9 of instructions—attach computation)		
28	Minimum tax on tax preference items (see page 9 of instructions—attach Form 4626)		
29	Alternative minimum tax (see Specific Instructions for line 29—attach Form 6251)		
30	Total tax (add lines 25 through 29)		NONE
31	Credits (a) Tax deposited with Form 7004		
	(b) Tax deposited with Form 7005 (attach copy)		
	(c) Foreign organizations—Tax paid or withheld at the source (see instructions)		
	(d) Credit from regulated investment companies (attach Form 2439)		
	(e) Federal tax on special fuels and oils (attach Form 4136)	110	110
32	TAX DUE (line 30 minus line 31). See General Instruction G for depositary method of payment ▶		
33	OVERPAYMENT TO BE REFUNDED (line 31 minus line 30) ▶		110

EXHIBIT NO. [f 265]

Unrelated Business Taxable Income Computation

Unrelated Trade or Business Income	
1 Gross receipts or gross sales ....., minus returns and allowances ..... Balance ▶	85,647
2 Minus: Cost of goods sold (Schedule A) and/or operations (Schedule B)	84,000
3 Gross profit	1,647
4 (a) Capital gain net income—(attach separate Schedule D)	
(b) Net gain or (loss) from Part II, Form 4797 (attach copy)	
(c) Capital loss deduction for trusts	
5 Income or (loss) from partnerships (attach statement)	
6 Rent income (Schedule C)	
7 Unrelated debt-financed income (Schedule E)	
8 Investment income of a 501(c)(7) or (9) organization (Schedule F)	
9 Interest, annuities, royalties, and rents from controlled organizations (Schedule G)	
10 Exploited exempt activity income (Schedule H)	
11 Advertising income (Schedule I, Part III, Column A)	
12 Other income (see page 7 of instructions—attach schedule)	
13 TOTAL unrelated trade or business income (add lines 3 through 12)	1,647
Deductions Not Taken Elsewhere	
(Except for contributions, deductions must be directly connected with the unrelated business income)	
14 Compensation of officers, directors and trustees (Schedule J)	
15 Salaries and wages....., minus WIN credit ..... Balance ▶	8,634
16 Repairs (see instructions)	1,219
17 Bad debts (see instructions)	
18 Interest (attach schedule)	50
19 Taxes Property & payroll	2,812
20 Contributions (see page 7 of instructions for limitations—attach schedule)	
21 Depreciation (attach Form 4562)	4,992
22 Amortization (attach schedule)	
23 Depletion	
24 (a) Contributions to deferred compensation plans (see page 8 of instructions)	
(b) Employee benefit programs (see page 8 of instructions)	
25 Other deductions (attach schedule)	12,373
26 TOTAL deductions (add lines 14 through 25)	30,080
27 Unrelated business taxable income before allowable advertising loss (line 13 minus line 26)	(28,433)
28 Minus: Advertising loss (Schedule I, Part III, Column B)	
29 Unrelated business taxable income before net operating loss deduction (line 27 minus line 28)	(28,433)
30 Minus: Net operating loss deduction (see page 8 of instructions—attach schedule)	(156,987)
31 Unrelated business taxable income before specific deduction (line 29 minus line 30)	
32 Minus: Specific deduction (see General Instruction O(4))	
33 Unrelated business taxable income (line 31 minus line 32)	(185,420)

Schedule A—COST OF GOODS SOLD (See Specific Instructions)

Method of inventory valuation (specify) ▶

1 Inventory at beginning of year	
2 Merchandise bought for manufacture or sale	
3 Salaries and wages	
4 Other costs (attach schedule)	
5 TOTAL	
6 Minus inventory at end of year	
7 Cost of goods sold (enter here and on line 2, page 2)	

Schedule B—COST OF OPERATIONS

1 Salaries and wages	
2 Other costs (to be detailed):	
(a) SEE SCHEDULE ATTACHED	
(b)	
(c)	
(d)	
(e)	
3 TOTAL (enter here and on line 2, page 2)	84,000

The books are in care of ▶ Mr. Donald Nellis Telephone number ▶ (503) 292-2651

Schedule C—RENT INCOME FROM REAL PROPERTY AND PERSONAL PROPERTY LEASED WITH REAL PROPERTY (See Specific Instructions for Line 6)

1. Description of property	2. Rent received or accrued	3. Percentage of rent attributable to personal property
		%
		%
		%

4. Complete for any item in column 3 which is more than 50%, or for any item if the rent is determined on the basis of profit or income		5. Complete for any item in column 3 which exceeds 10% and is not more than 50%		
(a) Deductions directly connected (Attach schedule)	(b) Income includible (Column 2 minus column 4(a))	(a) Gross income reportable (Column 2 × column 3)	(b) Deductions directly connected with personal property (Attach schedule)	(c) Income includible (Column 5(a) minus column 5(b))

Add 4(b) and 5(c) and enter total here and on line 6, page 2 . . . . . .

Schedule E—UNRELATED DEBT-FINANCED INCOME (See Specific Instructions for Line 7)

1. Description of debt-financed property	2. Gross income from or allocable to debt-financed property	3. Deductions directly connected with or allocable to debt-financed property	
		(a) Straight line depreciation (Attach schedule)	(b) Other deductions (Attach schedule)

4. Amount of average acquisition indebtedness on or allocable to debt-financed property (Attach schedule)	5. Average adjusted basis of or allocable to debt-financed property (Attach schedule)	6. Percentage which column 4 is of column 5	7. Gross income reportable (Column 2 × column 6)	8. Allocable deductions (Total of columns 3(a) and (b) × column 6)	9. Net income or (loss) includible (Column 7 minus column 8)
		%			
		%			
		%			

Total (enter here and on line 7, page 2) . . . . . .

Total of dividends-received deduction included in column 8 . . . . . .

Schedule F—INVESTMENT INCOME OF A 501(c)(7) OR (9) ORGANIZATION (See Specific Instructions for Line 8)

(a) Description	(b) Amount	(c) Deductions directly connected (Attach schedule)	(d) Net investment income (Column (b) minus column (c))	(e) Set Asides (Attach schedule)	(f) Balance of investment income (Column (d) minus column (e))

Total (enter here and on line 8, page 2) . . . . . .

Schedule G—INCOME (ANNUITIES, INTEREST, RENTS AND ROYALTIES) FROM CONTROLLED ORGANIZATIONS (See Specific Instructions for Line 9)

1. Name and address of controlled organization(s)	2. Gross income from controlled organization(s)	3. Deductions of controlling organization (directly connected with column 2 income) (Attach schedule)	4. Exempt controlled organizations		
			(a) Unrelated business taxable income	(b) Taxable income computed as though not exempt under section 501(c) or the amount in column (a), whichever is more	(c) Percentage which column (a) is of column (b)
					%
					%

5. Nonexempt controlled organizations			6. Gross income reportable (Column 2 × column 4(c) or column 5(c))	7. Allowable deductions (Column 3 × column 4(c) or column 5(c))	8. Net income includible (Column 6 minus column 7)
(a) Excess taxable income	(b) Taxable income or amount in column (a), whichever is more	(c) Percentage which column (a) is of column (b)			
		%			
		%			

Total (enter here and on line 9, page 2) . . . . . .

Schedule H—EXPLOITED EXEMPT ACTIVITY INCOME, OTHER THAN ADVERTISING INCOME (See Specific Instructions for Line 10)

1. Description of exploited activity	2. Gross unrelated business income from trade or business	3. Expenses directly connected with production of unrelated business income	4. Net income from unrelated trade or business (Column 2 minus column 3)	5. Gross income from activity that is not unrelated business income	6. Expenses attributable to column 5	7. Excess exempt expenses (Column 6 minus column 5 but not to exceed amount in column 4)	8. Net income includible (Column 4 minus column 7)

Total (enter here and on line 10, page 2) . . . . . .

Schedule I—ADVERTISING INCOME AND ADVERTISING LOSS (See Specific Instructions for Line 11)

Part I—Income from periodicals reported on consolidated basis

1. Name of periodical	2. Gross advertising income	3. Direct advertising costs	4. Advertising gain or loss (col. 2 minus col. 3). If loss, enter in col. B, Part III. Do not complete col's. 5, 6 and 7. If gain, complete col's. 5, 6 and 7.	5. Circulation income	6. Readership costs	7. If col. 5 exceeds col. 6, enter in col. A, Part III, the gain shown in col. 4. If col. 6 exceeds col. 5, subtract col. 6 plus col. 3 from col. 5 plus col. 2. Enter gain in col. A, Part III.
Totals						

Part II—Income from periodicals reported on a separate basis

Part III—Column A—Advertising Income		Part III—Column B—Advertising Loss	
(a) Enter "consolidated periodical" and/or names of non-consolidated periodicals	(b) Enter total amount from column 4 or 7, Part I and amounts listed in cols. 4 and 7, Part II	(a) Enter "consolidated periodical" and/or names of non-consolidated periodicals	(b) Enter total amount from column 4, Part I and amounts listed in column 4, Part II
Enter total here and on line 11, page 2		Enter total here and on line 28, page 2	

Schedule J—COMPENSATION OF OFFICERS, DIRECTORS AND TRUSTEES

1. Name	2. Title	3. Time devoted to business	4. Total compensation

Total compensation of officers (enter total here and on line 14, page 2)

Schedule K—RECORD OF FEDERAL TAX DEPOSIT FORMS 503
(List deposits in order of date made—See Instruction G)

Date of deposit	Amount	Date of deposit	Amount

Date of deposit	Amount

Statements Regarding Certain Activities

	Yes	No
1 At any time during the tax year, did you have an interest in or a signature or other authority over a bank account, securities account, or other financial account in a foreign country (see instruction W)?		
2 Were you the grantor of or transferor to a foreign trust which existed during the current tax year, whether or not you have any beneficial interest in it? If "Yes," you may have to file Forms 3520, 3520-A or 926.		

Please Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▷ Signature of officer — Date — ▷ Title (Treasurer)

Paid Preparer's Information

Preparer's signature and date ▷ 1/8/80

Check if self-employed ▶ ☐ — Preparer's social security no. [illegible]

Firm's name (or yours, if self employed) and address ▷ ERNST & WHINNEY - 3300 First National Bank Tower, Portland, Oregon

E.I. No. ▶ 34-6565596

ZIP code ▶ 97201

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Form **4562**
Department of the Treasury
Internal Revenue Service

Depreciation

▶ See instructions.
▶ Attach this form to your return.

1979

Name(s) as shown on return
PORTLAND GOLF CLUB

Identifying number
93-0256880

Use this form as an attachment to an individual, partnership, fiduciary, or corporation return.

a. Description of property	b. Date acquired	c. Cost or other basis	d. Depreciation allowed or allowable in prior years	e. Method of computing depreciation	f. Life or rate	g. Depreciation for this year
1 Total additional first-year depreciation (do not include in items below) →						
2 Depreciation from Form 4832						
3 Other depreciation:						
Buildings	VARIOUS	631,223	455,498	SL	VAR	30,265
Furniture and fixtures . . .	VARIOUS	687,106	436,751	SL	VAR	36,676
Transportation equipment . .						
Machinery and other equipment .	VARIOUS	58,710	3,006	SL	VAR	5,041
Other (Specify)						
Improvements to grounds	VARIOUS	459,530	228,250	SL	VAR	16,729
Tennis courts	VARIOUS	22,464	11,236	SL	VAR	2,058
						90,769
			ALLOCABLE TO UNRELATED BUSINESS INCOME			5.5%
						4,992
4 Totals (add amounts in columns c and g) .		1,859,033				4,992

Individual and partnership filers should include totals from line 4 on the corresponding lines of their regular depreciation schedule. Form 1120 or any of the Form 1120 series (Form 1120S, 1120F, etc.) and Form 1041 filers should attach Form 4562 to their return and enter total of line 4, column g, on appropriate depreciation expense line in "Deductions" section of return.

Instructions

(Section references are to the Internal Revenue Code unless otherwise specified.)

Note: *Information on Class Life Asset Depreciation Range (CLADR) System and the limitation of straight line depreciation method for certain boilers fueled by oil or gas is contained in Publication 534, Depreciation.*

Purpose of Form.—This form is for use by individuals estates, trusts, partnerships, and corporations to report depreciation expense claimed on their return.

Reasonable Allowance.—You may deduct a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in a trade or business, or held to produce income. You may not take the allowance for stock in trade, inventories, land, personal assets or any property (including the allocable basis of any property) acquired with certain cost sharing payments described in section 126. To figure the allowance, write off the cost or other basis to be recovered over the expected useful life of the property.

Depreciation begins when the asset is placed in service and ends when it is retired from service. To figure the depreciation basis for personal property other than livestock, you do not have to take into account salvage value that is less than 10% of its cost or other basis. If the salvage value is more than 10%, take only the amount over 10% into account. These rules apply to property with a useful life of 3 or more years.

Depreciation Methods.—The methods of depreciation under section 167(b) are the following:

Straight Line Method.—To figure the depreciation on property for each year, divide its cost or other basis by its remaining useful life. Adjust its cost or other basis by

(Continued on back)

Form **4136**

Department of the Treasury
Internal Revenue Service

Computation of Credit for Federal Tax on Gasoline, Special Fuels, and Lubricating Oil

► Attach this form to your income tax return.

1979

23

Name (as shown on your income tax return)

PORTLAND GOLF CLUB

Social security or employer identification number

93-0256880

Part I

Type of Business Use	Gasoline, Diesel Fuel and Special Motor Fuels: Number of Gallons Used (A)	Rate of Tax (B)	Multiply Column (A) by Column (B) (C)	Lubricating Oil: Number of Gallons Used (D)	Rate of Tax (E)	Multiply Column (D) by Column (E) (F)
1 Nonhighway:						
a Farm (for farming purposes)		.02 .04 •	$		.06	$
b Commercial fishing vessel (See Instructions C.4. and D.2.(c)):						
(i) Gasoline		.02				
(ii) Diesel fuel or special fuels		.02 .04 •			.06	
c Other (specify) Unlicensed off-road vehicles	5,485	.02 .04 •	110		.06	
2 Intercity, local, and school buses (See Instruction C.3.)		.02 .04 •			.06 .06	
3 Aircraft						$
4 Totals			$			

Part II

Type of Business Use	Aviation Fuels: Fuels Other Than Gasoline (Example, Jet Fuel) Number of Gallons Used (A)	Gasoline Number of Gallons Used (B)	Rate of Tax (C)	Multiply Column (A) or (B) by Column (C) (D)
5 a Farm (for farming purposes) (Aerial applicators see instruction C.1.)			.07	$
			.04 .07 •	
b Aviation (applies only to commercial use as defined in instruction D.2.(d))			.04 .07 •	
			.07	
6 Total				$
7 Total income tax credit claimed. (Add line 4, columns (C) and (F) and line 6, column (D).) (See instruction B.)				$ 110

• Tax Rate (per gallon used)

Type of Use	Gasoline (Nonaviation Use)	Diesel Fuel and Special Motor Fuel	Aviation Fuel Gasoline
Farm (farming purposes)	4¢	2¢ or 4¢ whichever paid	4¢ or 7¢ whichever paid
Other	2¢	2¢ or 4¢ whichever paid	
Aviation (applies only to commercial use as defined in instruction D.2.(d))			4¢ or 7¢ whichever paid

Instructions

(Section references are to the Internal Revenue Code unless otherwise specified)

After December 31, 1978, gasoline, special fuels, and lubricating oil used for non-business, off-highway purposes (such as lawnmowers, snowmobiles, etc.) are not eligible for credit or refund.

Form 843 for Quarterly Tax Refund.—You may want to file a claim for a tax refund instead of a credit. To do so you must be able to claim at least $1,000 a quarter for any fuel category or lubricating oil. Use Form 843, Claim, for filing. File for any of the first three quarters of your tax year before the end of the next quarter. Show separate computations for a claim on gasoline, special fuels, and lubricating oils. Don't include gasoline or special fuels used on a farm for farming purposes. You may claim a credit only, not a refund, for tax paid on such fuel.

You may use Form 4136 as a worksheet to show your computations, and attach it to your Form 843.

Don't include on Form 4136 the credit you claim on Form 843 for any of the first three quarters of your tax year.

A. Purpose of Form 4136.—You must file this form if you claim credit for Federal excise tax on certain kinds of fuel. These include gasoline, special fuels, and lubricating oil as defined in instructions C, D, and E.

An individual, estate, trust, or corporation may file this form, but a partnership may not. However, when a partnership files Form 1065, U.S. Partnership Return of Income, it must include a statement showing:

- How many gallons of the fuels are allocated to each partner.
- The types of use, as shown in this form.

B. Year to Include the Credit Resulting from Business Use of Fuel or Oil.—When you claim a credit or refund, you must include it in your gross income to the extent it resulted in a reduction of your income

(Continued on back)

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TAX RETURN SCHEDULE

PORTLAND GOLF CLUB

Year Ended September 30, 1980

Cost of Goods Sold:

Salaries	$35,412
Food supplies	23,616
Liquor supplies	4,864
Payroll taxes	4,307
Employees' insurance	1,102
Employees' meals	1,384
Workmen's compensation insurance	1,126
Laundry	932
Electricity	1,069
Gas heat	987
Repairs & maintenance	3,401
Supplies	4,560
Cleaning	263
Cartage & hauling	295
Menus	189
Gas and oil	539
Flower & decorations	154
	$84,000

Interest:

Interest on contract payable to the University of Oregon Medical School	$ 50

Taxes:

Payroll taxes	$ 986
Property taxes	1,826
	$ 2,812

TAX RETURN SCHEDULE

PORTLAND GOLF CLUB

Year Ended September 30, 1980

Other Deductions:

Employees' meals	$ 255
Employees' insurance	284
Workmen's compensation insurance	315
Repairs and maintenance	Line 16 on 990-T
Supplies and other	1,563
Electricity	600
Gas heat	1,369
Water	237
Telephone	315
Flowers and decorations	370
Sundry	1,109
Automobiles	267
Dues	50
Directors' and committees' expense	873
Postage	367
Printing expense and members' bulletins	562
Professional services	575
Data processing	789
Laundry	268
Entertainment & tournaments	1,180
Liability insurance	1,025
	$ 12,373

Net Operating Loss Deduction:

Net operating loss for the year ending:

10/31/75	$ 11,831
10/31/76	23,302
10/31/77	57,778
10/31/78	39,943
10/31/80	24,133
	$156,987

[¶ 6271

Form 1128
(Rev. Jan. 1979)
Department of the Treasury
Internal Revenue Service

Application for Change in Accounting Period

(See instructions on page 4)

To be filed in triplicate.

Please type or print

Name: PORTLAND GOLF CLUB

Number and street: 5900 S.W. Scholls Ferry Road

City or town, State and ZIP code: Portland, Oregon 97225

Identifying number (See instructions): 93-0256880

Check one:
- ☐ Individual
- ☐ Partnership
- ☐ Corporation
- ☐ Estate or trust
- ☐ Electing small business corporation
- ☒ Tax exempt organization

SECTION A.—Applicable to All Filers

1(a) Present tax year ends: October 31

1(b) Permission is requested to change to a tax year ending: September 30

2 The above change will require a return for a short period — Beginning: November 1, 1979 — Ending: September 30, 1980

3 Return for short period will be filed with the Internal Revenue Service Center at: Ogden, Utah

4(a) Nature of your business or principal source of income: Membership Dues

4(b) Your area code and telephone number: 503-292-2651

(Continued on page 2)

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MAKE NO ENTRIES BELOW—For Internal Revenue Service Use Only

▶ Approval Action

Based solely upon the information furnished in your application, you are granted permission to make the requested change in accounting period indicated above, subject to conditions (a) through (h) below.

OCT 15 1980

Chief, Corporation Tax Branch — Date

▶ Disapproval Action

Your application cannot be approved for the following reason:

- ☐ Not timely filed. (See explanation ..... below.)
  - ( ) It was dated .....
  - ( ) It was received in envelope postmarked .....
- ☐ Prematurely filed. (See explanation 3 below.)
- ☐ No record of a timely filed application in this office. (See explanation ..... below.)

Chief, Corporation Tax Branch — Date

Person to contact ▶ Robert Halliday

Phone ▶ 202-566-6711

Symbols ▶ T:C:C:1:2

Internal Revenue Service
Washington, D.C. 20224

Conditions Applicable to Change

(a) Upon receiving approval, make the change by filing a return for the short period on or before the due date of the return, including extensions, or by the 30th day after date of approval action, whichever is later.

(b) You must close your books as of the last day of the new tax year.

(c) Attach to your short period return a statement that shows the date and symbols of the approval action and that the change is made by authority of that approval.

(d) Use an annual basis for any taxable income shown on the short period return and figure the tax in accordance with provisions of section 443(b) of the Internal Revenue Code. Make returns for subsequent tax years on the basis of the new tax year.

(e) In figuring taxable income for the short period, accrual basis taxpayers must reduce any expense covering a 12-month period (such as taxes, insurance, vacation pay, or similar expense) to an amount bearing the same ratio to the total expense as the number of months in the short period bears to 12; and deduct one-tenth of that reduction each year of a 10-year period commencing with the first tax year after the short period. Note.—*This condition is not applicable if you have consistently deducted such expenses on the ratable accrual method for Federal income tax purposes.*

(f) If there is a short-period loss exceeding $10,000 that is available for carryback to prior years, you must deduct one-tenth of the loss each year of the 10-year period, beginning with the first tax year after the short period.

(g) If there is an investment credit, work incentive (WIN) credit, etc., earned during the short period, and there is a short-period loss exceeding $10,000 that is available for carryback to prior years, you must not claim an investment credit, work incentive (WIN) credit, etc., carryback determined for that period. Instead, you must carry the credit(s) forward beginning with the first tax year after the short period. Any unused credit(s) may be carried over to each of the ten tax years following the short period.

(h) If the change in accounting period is for a corporation, it will not attempt to make an election (under section 1372(a) of the Code) to be taxed as a small business corporation, that would be effective for the tax year immediately following the short period.

Explanation of Disapproval Action

1. Section 1.442-1(b)(1) of the Income Tax Regulations provides that to secure prior approval of a change of annual accounting period you must file your application on or before the 15th day of the second calendar month following the close of the short period for which return is required.

2. Section 1.706-1(b)(4)(ii) of the Income Tax Regulations provides that where a newly formed partnership is required to obtain prior approval from the Commissioner for the adoption of a tax year, the partnership must file this application by the last day of the month following the close of the tax year to be adopted.

3. You filed the application too far in advance of the end of the short period. Please use the enclosed forms to make a new application closer to the end of the short period, when more accurate information will be available.

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SECTION A.—Applicable to All Filers (continued)

		Yes	No
5	What is your overall method of accounting? ☐ Cash receipts and disbursements ☒ Accrual ☐ Other (explain):		
6	Within the last 10 years, have you changed or requested permission to change your accounting period? . . . . . If "Yes," explain giving previous accounting period and the accounting period you changed to. If prior approval was granted, give date of letter and symbols shown on it.		X
7	Enter your taxable income* or (loss) for the three tax years immediately preceding the short period and for the short period. If necessary, estimate the amount for the short period.		

(Loss)

Third preceding year	Second preceding year	First preceding year	Short period
$ (57,778)	$ (39,943)	$ (24,133)	$ (22,122)*

* Individuals enter adjusted gross income. Partnerships enter ordinary income. Section 501(c) organizations enter amount of unrelated business taxable income.

*Estimate

8(a)	Are you a member of a partnership?		X
8(b)	Are you a beneficiary of a trust or an estate?		X
8(c)	Are you a shareholder of an electing small business corporation?		X
8(d)	If 8(a), 8(b), or 8(c) is "Yes," enter below the name, tax year, percentage of interest in capital and profits, and the amount of income received from each partnership, trust, estate, or small business corporation for the first preceding year and the short period. (Attach a separate sheet if more space is needed.)		
9	Are you a cooperative, within the meaning of, and filing under section 1381(a) of the Code?		X
10	If operations for the short period result in a (estimated) loss, show any amount available for carryback to prior years . . . . . $ NONE		
11	If you are engaged in a trade or business, enter the following for the tax year preceding the short period:		
	(a) Gross sales, if on accrual method . . . . . $		
	(b) Gross receipts, if on cash receipts and disbursements method . . . . . $		
12	If you are requesting change from a fiscal year to a calendar year, is it being made under Rev. Proc. 66-50? (See specific instructions in Section A, page 4.)		X

13 State your reasons for requesting the change. (Attach a separate sheet if more space is needed.)

SEE STATEMENT ATTACHED

SECTION B.—Estates or Trusts Only

Attach a statement showing the following information:

1 Name, social security number, address and tax year of each beneficiary and whether a beneficiary is also the grantor.

2 The taxable income of the estate or trust, the distribution deduction and the taxable amounts distributable to each beneficiary for the two tax years immediately preceding the short period and for the short period.

3 Dates during the year when distributions are made or are required to be made.

4 If you will not make distribution on these dates in the future, explain.

5 If the amount distributed or required to be distributed is not approximately the same for each period, explain.

		Yes	No
6	If the trust is a member of a Common Trust Fund, show name and tax year of that fund.		
7	Are you requesting the change under Rev. Proc. 68-41? (See specific instructions in Section B, page 4.)		

SECTION C.—Partnerships Only

1	Date business commenced. (See specific instructions in Section C, page 4.) ▶		
2	Is any partner applying for a corresponding change in accounting period?		
3	Attach a statement showing each principal partner's name, social security number, address, tax year, the percentage of interest in capital and profits, and how the interest was acquired.		
4	Transfer of partnership: Have any partners acquired their interest in partnership capital and profits within the 25 months preceding the date of this application? . . . . . If "Yes," show on attached statement the names and tax years of the partners, percentage of their interests in partnership capital and profits, and when and how those interests were acquired.		
5	Are any members of the partnership related to one another? . . . . . If "Yes," show on attached statement the names and relationships.		
6	Do the partners derive their principal gross income from the partnership? . . . . . If "No," show on attached statement the names of the partners who do not.		
7	Show on attached statement any capital gains or losses for the three tax years preceding the short period and for the short period		

Form 1128 (Rev. 1-79)

	Yes
SECTION D.—Corporations Only	
1 Date of incorporation ► April 7, 1914	
2 Is the change being made to join the parent in filing a consolidated return for the short period? If "Yes," see specific instructions in Section D, page 4	
3 Are you a member of an affiliated group filing a consolidated return? If "Yes," and if you are required to file this form, attach a statement showing (a) the name and address used on the consolidated return, the tax year and the Internal Revenue Service Center where you filed the return; and (b) the name and address of each member of the affiliated group. Designate the parent corporation and the taxable income or (loss) of each member for the three tax years preceding the short period and for the short period.	
4 Did the corporation pay any dividends to its shareholders during the short period?	
If "Yes," furnish the following information:	
(a) Taxable dividends $	
(b) Nontaxable dividends $	
(c) Total dividends $	
SECTION E.—Electing Small Business Corporations Only	
1 Date of election ►	
2 Enter the total amount treated as long-term capital gain in the short period $	
3 Attach a statement showing the name, address, tax year, and the percentage of ownership of each shareholder.	
4 Do the shareholders derive their principal gross income from the electing small business corporation? If "No," show on attached statement the names of the shareholders who do not.	
SECTION F.—Tax Exempt Organizations Only	
1 Form of organization. [X] Corporation [ ] Trust [ ] Other (Specify) ►	
2 Date of organization ► April 7, 1914	
3 Section of Code under which you are recognized as exempt ► 501(c)7	X
4 Have you been ruled to be tax exempt? If "Yes," enter date of ruling letter and the symbols on it ► 1941 - Symbols not available	X
5 (a) Are you required to file an annual return on Form 990 or Form 990-PF?	
(b) Are you requesting the change under Rev. Procs. 76-9 or 76-10? (See specific instructions in Section F, page 4.)	
(c) If a private foundation, are you terminating your status under section 507 of the Code?	
6 Are you required to file an annual return on Form 990-C, Form 990-T, or Form 1120-POL?	X

Signature

Under penalties of perjury, I declare that I have examined this application (including any accompanying schedules and statements), a the best of my knowledge and belief it is true, correct, and complete. Declaration of preparer (other than applicant) is based on all inf tion of which preparer has any knowledge.

Individual's signature — Date

Spouse's signature — Date

PORTLAND GOLF CLUB, INC
Partnership, corporate, estate or trust name

Official's signature — CLUB TREASURER (Title) — 9/30/80 (Date)

(DONALD O. HELLIS')

Signature of individual or firm preparing the Application (see General Instructions on page 4) — Date

ERNST & WHINNEY - 3300 First National Bank Tower, Portland, OR 97201

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PORTLAND GOLF CLUB

APPLICATION FOR CHANGE IN ACCOUNTING PERIOD

September 30, 1980

REASON FOR REQUESTING THE CHANGE:

Because of weather conditions in the Northwest, club usage by members will substantially decrease after September. The reduced activity after September will facilitate more effective utilization of our personnel in the operation of closing our books. Additionally, the new year-end will facilitate more meaningful information for management and members in planning the coming year. Furthermore, the majority of similar organizations in the area have September year-ends. Adoption of a similar fiscal year-end will permit easier comparison with the operating figures of these organizations.

It should be noted that except for the anticipated short period loss on unrelated business income, the applicant would qualify for an automatic change in year-ends. The applicant has historically generated losses in its unrelated business income which constitutes only 4% of its gross receipts. These losses are generated prorata throughout the year and the requested change should not accelerate losses or create taxable income eligible for offset by prior net operating losses.

As the applicant has always generated losses on its unrelated business income, the anticipated short period loss would not be eligible for carryback to prior years.

Form 990-T
Department of the Treasury
Internal Revenue Service

Tax Return (Under Section 511 of the Internal Revenue Code)

For calendar year 1980 or fiscal year beginning OCTOBER 1, 1980, and ending SEPTEMBER 30, 1981

1980

Name of organization: PORTLAND GOLF CLUB 29347200 10000

Address (number and street): 5900 S.W. Scholls Ferry Road

City or town, State, and ZIP code: Portland, Oregon 97225

A Employer identification number (employees' trust see instruction for Block A): 93 | 0256880

B Enter unrelated business activity codes from page 8 of instructions

C Check box if address changed . . . . . ▶ ☐

D Exempt under section . . . . . ▶ 501 (C)(7)

E Check applicable box . . . ▶ ☒ Corporation ☐ Trust

F Group exemption number (see instructions for Block F) ▶

Complete page 1, Schedule K on page 2, and sign the return if the unrelated trade or business gross income is $10,000 or less.
Complete all applicable parts of the form (except lines 1 through 5) if unrelated trade or business gross income is over $10,000.

Unrelated Business Taxable Income Computation—When Unrelated Trade or Business Gross Income is $10,000 or Less

1	Unrelated trade or business gross income. (State sources _____)	1	
2	Minus deductions	2	
3	Unrelated business taxable income before specific deduction	3	
4	Minus specific deduction (see instructions for line 32)	4	
5	Unrelated business taxable income	5	(268,706)

Tax Computation

Organizations Taxable as Corporations (See Instructions for Tax Computation)

6 (a) Are you a member of a controlled group? ☐ Yes ☒ No

(b) If "Yes," see instructions and enter your share of the $25,000 amount in each taxable income bracket:
(i) $_____ (ii) $_____ (iii) $_____ (iv) $_____

7	Income tax on amount on line 5 above, or line 33, page 2, whichever applies. Check here ▶ ☐ if alternative tax from Schedule D (Form 1120) is used	7	NONE
	Trusts Taxable at Trust Rates (See Instructions for Tax Computation) Section 401(a) trust, check here ▶ ☐		
8	Enter the tax from the tax rate schedule in instructions on amount on line 5 above, or line 33 on page 2, whichever applies	8	NONE

Total Income Tax

9	(a) Foreign tax credit (corporations attach Form 1118, trusts attach Form 1116)	9(a)			
	(b) Investment credit (attach Form 3468)	9(b)			
	(c) Work incentive (WIN) credit (attach Form 4874)	9(c)			
	(d) Other credits (see instructions)	9(d)			
10	Total (add lines 9(a) through (d))			10	
11	Subtract line 10 from line 7 or line 8			11	
12	Increase in tax from refiguring an earlier year investment credit (attach Form 4255)			12	
13	Minimum tax on tax preference items (see instructions for line 13)			13	
14	Alternative minimum tax (see instructions for line 14)			14	
15	Total tax (add lines 11 through 14)			15	
16	Credits and payments: (a) Tax deposited with Form 7004	16(a)			
	(b) Tax deposited with Form 7005 (attach copy)	16(b)			
	(c) Foreign organizations—Tax paid or withheld at the source (see instructions)	16(c)			
	(d) Credit from regulated investment companies (attach Form 2439)	16(d)			
	(e) Federal tax on special fuels and oils (attach Form 4136)	16(e)	114		
	(f) Other payments and credits (see instructions)	16(f)			
	(g) Total credits and payments (add lines 16(a) through 16(f))			16(g)	114
17	TAX DUE (Subtract line 16(g) from line 15). See instructions for depositary method of payment →			17	
18	If line 16(g) is more than line 15, enter OVERPAYMENT →			18	114

Statements Regarding Certain Activities

		Yes	No
1	At any time during the tax year, did you have an interest in or a signature or other authority over a bank account, securities account, or other financial account in a foreign country (see instructions)?		X
2	Were you the grantor of or transferor to a foreign trust which existed during the current tax year, whether or not you have any beneficial interest in it? If "Yes," you may have to file Forms 3520, 3520-A or 926.		X

Please Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Signature of officer: [signature] Date: 2/6/82 Title: Vice President

Paid Preparer's Use Only

Preparer's signature and date: [signature] 2-1-82

Check if self-employed ▶ ☐

Preparer's social security no.: J. L. ARBOW 541-62-42[illegible]

Firm's name (or yours, if self-employed) and address: ERNST & WHINNEY - 3300 First Interstate Tower, Portland, OR

E.I. No. ▶ 34-6565596

ZIP code ▶ 97201

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EXHIBIT NO. _____

Form 990-T (1980)

Unrelated Business Taxable Income Computation

Unrelated Trade or Business Income			
1 Gross receipts or gross sales ..... minus returns and allowances..... Balance ▶	1	85,586	
2 Minus: Cost of goods sold (Schedule A) and operations (attach schedule) . SEE SCHEDULE ATTACHED	2	118,055	
3 Gross profit	3	(32,469)	
4 (a) Capital gain net income (attach separate Schedule D)	4(a)		
(b) Net gain or (loss) from Part II, Form 4797 (attached)	4(b)		
(c) Capital loss deduction for trusts	4(c)		
5 Income or (loss) from partnerships (attach statement)	5		
6 Rent income (Schedule C)	6		
7 Unrelated debt-financed income (Schedule E, line 2)	7		
8 Investment income of a section 501(c)(7) or (9) organization (Schedule F)	8		
9 Interest, annuities, royalties, and rents from controlled organizations (Schedule G)	9		
10 Exploited exempt activity income (Schedule H)	10		
11 Advertising income (Schedule I, Part III, Column A)	11		
12 Other income (see instructions for line 12—attach schedule)	12		
13 TOTAL unrelated trade or business income (add lines 3 through 12)	13	(32,469)	
Deductions Not Taken Elsewhere (Except for contributions, deductions must be directly connected with the unrelated business income)			
14 Compensation of officers, directors and trustees (Schedule J)	14		
15 Salaries and wages 11,714 , minus WIN credit ..... Balance ▶	15	11,714	
16 Repairs (see instructions)	16	2,012	
17 Bad debts (see instructions)	17		
18 Interest (attach schedule)	18	46	
19 Taxes	19	3,640	
20 Contributions (see instructions for line 20)	20		
21 Depreciation (attach Form 4562)	21	5,153	
22 Amortization (attach schedule)	22		
23 Depletion	23		
24 (a) Contributions to deferred compensation plans (see instructions for line 24(a))	24(a)		
(b) Employee benefit programs (see instructions for line 24(b))	24(b)		
25 Other deductions (attach schedule)	25	14,574	
26 TOTAL deductions (add lines 14 through 25)	26	37,139	
27 Unrelated business taxable income before allowable advertising loss (subtract line 26 from line 13) . . .	27	(69,608)	
28 Minus: Advertising loss (Schedule I, Part III, Column B)	28		
29 Unrelated business taxable income before net operating loss deduction (subtract line 28 from line 27) . .	29	(69,608)	
30 Minus: Net operating loss deduction (see instructions for line 30)	30	199,098	
31 Unrelated business taxable income before specific deduction (subtract line 30 from line 29)	31	(268,706)	
32 Minus: Specific deduction (see instructions for line 32)	32		
33 Unrelated business taxable income (subtract line 32 from line 31)	33	(268,706)	

Schedule A—COST OF GOODS SOLD (See Instructions for Line 2 above)

Method of inventory valuation (specify) ▶

Inventory at beginning of year		
Merchandise bought for manufacture or sale . . .		
Salaries and wages		
Other costs (attach schedule)		
TOTAL		
Minus Inventory at end of year		
Cost of goods sold (enter here and on line 2, above) .		

Schedule K—RECORD OF FEDERAL TAX DEPOSIT FORMS 503

(List deposits in order of date made--See Instruction for line 17, page 1)

Date of deposit	Amount

Books are in care of ▶ Mr. Donald Nellis Telephone number ▶ (503) 292-2651

Schedule C—RENT INCOME FROM REAL PROPERTY AND PERSONAL PROPERTY LEASED WITH REAL PROPERTY (See Instructions for line 6 of page 2)

1. Description of property	2. Rent received or accrued	3. Percentage of rent for personal property
		%
		%
		%
		%
		%

4. Complete for any item if the entry in column 3 is more than 50%, or if the rent is based on profit or income		5. Complete for any item if the entry in column 3 is more than 10% but not more than 50%		
(a) Deductions directly connected (Attach schedule)	(b) Income includible (Column 2 minus column 4(a))	(a) Gross income reportable (Column 2 × column 3)	(b) Deductions directly connected with personal property (Attach schedule)	(c) Income includible (Column 5(a) minus column 5(b))

Add columns 4(b) and 5(c) and enter total here and on line 6, page 2 . . . . . .

Schedule E—UNRELATED DEBT-FINANCED INCOME. (See Instructions for line 7 of page 2)

1. Description of debt-financed property	2. Gross income from or allocable to debt-financed property	3. Deductions directly connected with or allocable to debt-financed property	
		(a) Straight line depreciation (Attach schedule)	(b) Other deductions (Attach schedule)
1			

4. Amount of average acquisition indebtedness on or allocable to debt financed property (Attach schedule)	5. Average adjusted basis of or allocable to debt financed property (Attach schedule)	6. Percentage which column 4 is of column 5	7. Gross income reportable (Column 2 × column 6)	8. Allocable deductions (Total of columns 3(a) and 3(b) × column 6)	9. Net income or (loss) includible (Column 7 minus column 8)
		%			
		%			
		%			
		%			

2 Total (enter here and on line 7, page 2) . . . . . .

3 Total dividends-received deductions included in column 8 . . . . . .

Schedule F—INVESTMENT INCOME OF A SECTION 501(c)(7) OR (9) ORGANIZATION (See Instructions for Line 8 of Page 2)

(a) Description	(b) Amount	(c) Deductions directly connected (Attach schedule)	(d) Net investment income (Column (b) minus column (c))	(e) Set-asides (Attach schedule)	(f) Balance of investment income (Column (d) minus column (e))

Total (enter here and on line 8, page 2) . . . . . .

Schedule G—INCOME (ANNUITIES, INTEREST, RENTS AND ROYALTIES) FROM CONTROLLED ORGANIZATIONS (See Instructions for Line 9 of Page 2)

1. Name and address of controlled organization(s)	2. Gross income from controlled organization(s)	3. Deductions of controlling organization directly connected with column 2 income (Attach schedule)	4. Exempt controlled organizations		
			(a) Unrelated business taxable income	(b) Taxable income computed as though not exempt under section 501(a) or the amount in column (a), whichever is more	(c) Percentage which column (a) is of column (b)
					%
					%
					%

5. Nonexempt controlled organizations			6. Gross income reportable (Column 2 × column 4(c) or column 5(c))	7. Allowable deductions (Column 3 × column 4(c) or column 5(c))	8. Net income includible (Column 6 minus column 7)
(a) Excess taxable income	(b) Taxable income or amount in column (a), whichever is more	(c) Percentage which column (a) is of column (b)			
		%			
		%			
		%			

Total (enter here and on line 9, page 2) . . . . . .

Schedule H—EXPLOITED EXEMPT ACTIVITY INCOME, OTHER THAN ADVERTISING INCOME
(See Instructions for Line 10 of Page 2)

1. Description of exploited activity	2. Gross unrelated business income from trade or business	3. Expenses directly connected with production of unrelated business income	4. Net income from unrelated trade or business (Column 2 minus column 3)	5. Gross income from activity that is not unrelated business income	6. Expenses attributable to column 5	7. Excess exempt expenses (Column 6 minus column 5 but not more than column 4)	8. Net income includible (Column 4 minus column 7)
Total (enter here and on line 10, page 2)							

Schedule I—ADVERTISING INCOME AND ADVERTISING LOSS (See Instructions for Line 11 of Page 2)

Part I—Income from periodicals reported on consolidated basis

1. Name of periodical	2. Gross advertising income	3. Direct advertising costs	4. Advertising gain or loss (col. 2 minus col. 3). If loss, enter in col. B, Part III. Do not complete cols. 5, 6 and 7. If gain, complete cols. 5, 6 and 7.	5. Circulation income	6. Readership costs	7. If col. 5 exceeds col. 6, enter in col. A, Part III, the gain shown in col. 4. If col. 6 exceeds col. 5, subtract col. 6 plus col. 3 from col. 5 plus col. 2. Enter gain in col. A, Part III.
Totals						

Part II—Income from periodicals reported on a separate basis

Part III—Column A—Advertising Income

Enter "consolidated periodical" or names of non-consolidated periodicals	(b) Enter total amount from column 4 or 7, Part I and amounts listed in cols. 4 and 7, Part II
Enter total here and on line 11, page 2	

Part III—Column B—Advertising Loss

(a) Enter "consolidated periodical" or names of non-consolidated periodicals	(b) Enter total amount from column 4, Part I and amounts listed in column 4, Part II
Enter total here and on line 28, page 2	

Schedule J—COMPENSATION OF OFFICERS, DIRECTORS AND TRUSTEES

1. Name	2. Title	3. Time devoted to business	4. Total compensation
Total compensation of officers (enter total here and on line 14, page 2)			

Form **4136**

Department of the Treasury
Internal Revenue Service

Computation of Credit for Federal Tax on Gasoline, Special Fuels, and Lubricating Oil

► Attach this form to your income tax return.

1980

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Name (as shown on your income tax return)
PORTLAND GOLF CLUB

Social security or employer identification number
93-0256880

Part I

Type of Business Use	Gasoline, Diesel Fuel and Special Motor Fuels: Number of Gallons Used (A)	Rate of Tax (B)	Multiply Column (A) by Column (B) (C)	Lubricating Oil: Number of Gallons Used (D)	Rate of Tax (E)	Multiply Column (D) by Column (E) (F)
1 Nonhighway:						
a Farm (for farming purposes)		.02 .04 •	$		.06	$
b Commercial fishing vessel (See Instructions C.4. and D.2.(c)):						
(i) Gasoline		.02				
(ii) Diesel fuel or special fuels		.02 .04 •			.06	
c Other (specify) Unlicensed off-road vehicle	5,697	.02 .04 •	114		.06	
2 Intercity, local, and school buses (See instruction C.3.)		.02 .04 •			.06	
3 Gasoline/alcohol mixture		.04			.06	
4 Aircraft						
5 Totals			$ 114			$

Part II

Type of Business Use	Aviation Fuels: Fuels Other Than Gasoline (Example, Jet Fuel) Number of Gallons Used (A)	Gasoline Number of Gallons Used (B)	Rate of Tax (C)	Multiply Column (A) or (B) by Column (C) (D)
6 a Farm (for farming purposes) (Aerial applicators see Instruction C.1.)			.07	$
			.04 .07 •	
b Aviation (applies only to commercial use as defined in instruction D.2.(d))			.04 .07 •	
			.07	
7 Total				$
8 Total income tax credit claimed. (Add line 5, columns (C) and (F) and line 7, column (D).) (See Instruction B.)				$ 114

• Tax Rate (per gallon used)

Type of Use	Gasoline (Nonaviation Use)	Diesel Fuel and Special Motor Fuel	Aviation Fuel Gasoline
Farm (farming purposes)	4¢	2¢ or 4¢ whichever paid	4¢ or 7¢ whichever paid
Other	2¢	2¢ or 4¢ whichever paid	
Aviation (applies only to commercial use as defined in instruction D.2.(d))			4¢ or 7¢ whichever paid

Instructions

(Section references are to the Internal Revenue Code unless otherwise specified)

At the time we printed this form, Congress was considering proposals that could change the credit computation for some of the items listed on the form. If the proposals become law and apply to 1980, they must be considered in figuring your credit for 1980. We will use news media and other means available to provide you with information and instructions on any changes.

New Law.—Line 3

Beginning January 1, 1979, a taxpayer who mixed alcohol with gasoline on which the 4-cents-a-gallon Federal excise tax has been imposed is eligible for a credit or refund of the gasoline tax. The alcohol must have been made from other than petroleum, natural gas, or coal. The mixture must have included at least 10% of 190 proof alcohol and must have been sold or used in the taxpayer's trade or business.

Gasoline used in the mixture from January 1, 1979, through April 1, 1980, is considered sold or used on April 2, 1980, for purposes of claiming a refund or credit.

Form 843 for Quarterly Tax Refund.—You may want to file a claim for a tax refund instead of a credit. To do so you must be able to claim at least $1,000 ($200 for gasoline/alcohol mixture) a quarter for any fuel category or lubricating oil. Use Form 843, Claim, for filing. File for any of the first three quarters of your tax year before the end of the next quarter. Show separate computations for a claim on gasoline, special fuels, and lubricating oils. Don't include gasoline or special fuels used on a farm for farming purposes. You may claim a credit only, not a refund, for tax paid on such fuel.

You may use Form 4136 as a worksheet to show your computations, and attach it to your Form 843. Don't include on Form 4136 the credit you claim on Form 843 for any of the first three quarters of your tax year.

A. Purpose of Form 4136.—You must file this form if you claim credit for Federal excise tax on certain kinds of fuel. These include gasoline, special fuels, and lubricating oil as defined in instructions C, D, and E.

An individual, estate, trust, or corporation may file this form, but a partnership may not. However, when a partnership files Form 1065, U.S. Partnership Return of Income, it must include a statement showing:

- How many gallons of the fuels are allocated to each partner.

(Continued on back)

Form **4562**
(Rev. September 1981)
Department of the Treasury
Internal Revenue Service (O)

Depreciation

▶ See separate instructions.
▶ Attach this form to your return.

OMB No. 1545-0172
Expires 12/31/82

Name(s) as shown on return: PORTLAND GOLF CLUB

Identifying number: 93-0256880

▶ Generally, you must use the Accelerated Cost Recovery System of depreciation (ACRS) for all assets you placed in service after December 31, 1980. Report these assets in Part I, lines 1(a) through 1(f).

▶ You may elect to exclude certain property. Report this property in Part I, line 2.

▶ Use Part II for assets you placed in service before January 1, 1981, and certain other assets for which you cannot use ACRS.

▶ Filers of Schedule C (Form 1040), Schedule E (Form 1040) and Form 4835 should see the instructions for those forms before completing Form 4562.

Part I Assets placed in service after December 31, 1980

A. Class of property	B. Date placed in service	C. Cost or other basis	D. Recovery period	E. Method of figuring depreciation	F. Percentage	G. Deduction for this year
1 Accelerated Cost Recovery System (ACRS) (See instructions for grouping assets):						
(a) 3-year property	1981	11,300	3		25	2,825
(b) 5-year property	1981	41,874	5		15	6,280
(c) 10-year property						
(d) 15-year public utility property	6/01/81	28,607	15	SL	2.22	635
	7/01/81	6,610	15	SL	1.67	110
	9/01/81	10,333	15	SL	.56	58
	7/01/81	35,766	15	SL	1.67	597
(e) 15-year real property—low-income housing					TOTAL	10,505
		ALLOCABLE TO UNRELATED BUSINESS INCOME			5.02% =	527
(f) 15-year real property other than low-income housing						
2 Property subject to section 168(e)(2) election (see instructions):						
3 Totals (add amounts in columns C and G)		134,490				527
4 Depreciation from Part II, line 3						4,626
5 Total (add column G, lines 3 and 4). Enter this amount on the depreciation expense line (where it applies) of your return						5,153

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Part II Assets placed in service before January 1, 1981 and other assets not qualifying for ACRS

A. Description of property	B. Date acquired	C. Cost or other basis	D. Depreciation allowed or allowable in earlier years	E. Method of figuring depreciation	F. Life or rate	G. Depreciation for this year
1 Class Life Asset Depreciation Range (CLADR) System Depreciation					▶	
2 Other depreciation (for grouping assets, see instructions for Part II):						
Buildings	VARIOUS	631,223	485,763	SL	VAR.	27,427
Furniture and fixtures	VARIOUS	692,454	473,427	SL	VAR.	32,543
Transportation equipment						
Machinery and other equipment	VARIOUS	58,710	8,047	SL	VAR.	8,600
Other (specify)						
Gounds/course imp	VARIOUS	459,530	244,979	SL	VAR.	21,335
Tennis courts	VARIOUS	22,464	13,294	SL	VAR.	2,246
					TOTAL	92,151
		ALLOCABLE TO UNRELATED BUSINESS INCOME				5.02% = 4,626
3 Total (add amounts in column G). Enter here and in Part I, line 4						4,626

• U.S.GPO:1981-0-343-166 E10 430214328

TAX RETURN SCHEDULE
PORTLAND GOLF CLUB 93-0256880
Year Ended September 30, 1981

Cost of Goods Sold	
Salaries	$ 55,051
Food supplies	24,059
Liquor supplies	5,401
Payroll taxes	6,015
Employees' insurance	1,689
Employees' meals	1,405
Workmen's compenstaion insurance	2,019
Laundry	1,133
Electricity	2,362
Gas heat	1,103
Repairs & maintenance	7,143
Supplies	8,160
Cleaning	202
Cartage & hauling	300
Menus	109
Gas and oil	1,031
Flowers & decorations	163
Battery replacement	710
	$118,055
Taxes	
Payroll taxes	$ 1,416
Property taxes	2,224
	$ 3,640
Interest	
Interest on contract payable to the University of Oregon Medical School	$ 46

TAX RETURN SCHEDULE
PORTLAND GOLF CLUB 93-0256880
Year Ended September 30, 1981

Other Deductions		
Employees' meals		$ 342
Employees' insurance		527
Workmen's compensation insurance		445
Repairs and maintenance	Page 2, Line 16 on 990-T	
Supplies and other		1,265
Electricity		725
Gas heat		1,481
Water		483
Telephone		335
Flowers and decoration		461
Sundry		2,030
Automobile		280
Dues		115
Directors' and committees' expense		873
Postage		439
Printing expense and members' bulletins		589
Professional services		436
Data processing		630
Laundry		730
Entertainment & tournaments		1,432
Liability insurance		956
		$ 14,574

Net Operating Loss Deduction
Net operating loss deduction for the year ending:

10/31/74	$ 13,678
10/31/75	11,831
10/31/76	23,302
10/31/77	57,778
10/31/78	39,943
10/31/79	24,133
09/30/80	28,433
	$199,098

TO: Board of Directors - PGC

FROM: Finance Committee

DATE: August 12, 1981

The Finance Committee has performed a review of the club dining room operations. The purpose of this review was to determine whether the dining room operations result in a reasonable departmental income (loss) based upon menu pricing, expenses, service considerations and type of function.

Our conclusions are set forth on the attached.

Dennis T. Pixton
Committee Chairman

EXHIBIT NO. _____

Menu Pricing

In order to determine the reasonableness of menu pricing, we compared the prices of various menu items between PGC and several middle class restaurants in the area.

These comparisons are:

Lunch	High	Low	PGC
Hamburger	3.75	2.75	2.75
Steak sandwich	7.95	5.95	7.25
Clubhouse	4.25	3.25	3.25
Rueben	5.75	3.50	3.50
Chefs salad	3.95	3.50	3.50
Dinner			
New York steak	16.50	11.00	11.00
Filet mignon	16.50	9.95	10.75
Lobster tail	21.95	12.95	14.00
Chicken	8.50	6.25	8.50

Limited conclusions can be drawn from these comparisons because it is difficult to determine meal condiments, level of service, etc. However, it appears that PGC may be on the low side in terms of menu pricing.

We also reviewed the basis for menu pricing with the club manager. And we found pricing methodology to be very comprehensive and inclusive of all relevant costs. However menu pricing is based on costs at the time prices are determined and does not reflect anticipated inflationary cost increases. Also, menu pricing does not reflect relative demand among various menu items. Assuming that all items offered are appealing, excessive price spread among entrees encourages members to order lower priced items, which seem like a relative bargain, since the same service and atmosphere go along with them as with the higher-priced items. A concentration of orders among low-priced entrees is generally undesirable because they offer a smaller dollar contribution toward fixed costs and profits even though the contribution as a percentage of sales may equal that from higher-priced items.

With these two observations in mind, we have two recommendations with regard to menu pricing:

1. Menu items should be priced based upon current costs plus a factor for anticipated cost increases. For example if menu pricing is expected to be changed twice each year then a price change at any given point in time, say June 1, should be based upon costs at June 1, plus anticipated cost increases to the next price change say December 1. As an example:

Cost of New York steak dinner as of 6/1	$ 10.00
Selling price	14.00
Margin	4.00 or 40%
Anticipated inflationary effects on costs from 6/1/ to 12/1	5%
Pricing at 6/1 - 10.00 x (5% ÷ 2) =	10.25
Margin	140%
	14.35

The additional 35¢ margin assures that the profit contribution of a New York steak does not decrease as a result of inflation.

2. An analysis of sales by menu item should be made. Then, in general, the high-priced items should be made less expensive and the low-priced items should be made more expensive while maintaining quality and portions. Assuming that there is generally a higher margin among the higher-priced menu items this should result in improving the bottom line by making the more expensive (higher margin) items more price attractive while actually improving the margin of the lower-priced (lower margin) menu items. This same analysis can be extended to the bar operations. Some improvement of the bottom line can be made by marginally raising the price of beer and wine while keeping the price of the liquor drinks at the same level.

We feel that the bottom line (dining room) can be improved by as much as 10% - 15% by following these suggestions.

Expense

We compared costs between PGC and other Country Clubs in the area and between PGC and other Country Clubs in the far-west. That comparison is:

Food only % of sales	PGC 6 mos. end. 3/31/81	Columbia-Edgewater 9/30/80	Riverside 8/31/80	Oswego Lake 9/30/80	Far West 1979
Food	46%	64%	46%	52%	47%
Salaries	61	56	53	57	N/A
Other expense	15	7	14	20	N/A
Total expense	122	127	113	129	N/A
Net loss	13	27	5	29	N/A

Food and beverage % of sales	PGC	Far West
Food and bar sales	100%	100.0%
Cost of sales	46	41.7
Net income	(1)	(2.3)

From the above tables, it appears the the cost of food is somewhat lower than the average for the Portland area. Labor appears to be one area which could be subject to improvements if desired.

In our opinion, expenses are reasonable and based upon our monthly review of the club financial statements are being well controlled.

Service

Based upon the 3/18/80 survey of members, PGC members generally rate food and the food service staff as either average or above average. See excerpts below:

DINING ROOM

	TIMES PER MONTH				
	1-5	6-10	11-15	over 15	Totals
Breakfast	164	3			167 (45.8%)
Lunch	183	99	36	6	324 (88.8%)
Dinner	286	5			291 (79.8%)

Of the 365 total respondents less than one-half eat breakfast at the club and greater than 75% use the luncheon and dining facilites at least once per month. The availability of breakfast service (4 days/month) as compared to 12 days/month for dinner and 24 days/month for lunch dictates the proportionate responses. In general most repondents ate dinner only 1 time per month and lunch at least 2 to 3 times.

	TABULATION RESULTS					PERCENTAGE RESULTS					
	Above Average	Average	Fair	Poor	Totals	Above Average %	Average %	Combined Average & Above Avg. Ratings	Fair %	Poor %	Combined Fair Poor Ratings
A. FOOD											
1. Breakfast	90	107	12	2	211	42.7	50.7	[93.4]	5.7	.009	[5.8]
2. Lunch	101	195	30	5	331	30.5	58.9	[89.4]	9.1	1.5	[10.6]
3. Dinner	100	155	59	10	324	30.9	47.9	[78.7]	18.2	3.1	[21.3]
4. Private Parties	113	45	16	2	176	64.2	25.6	[89.6]	9.1	1.1	[10.2]
Totals	404	502	117	19	1042	38.8	48.2	[87.]	11.2	1.8	[13.]
B. FOOD SERVICE STAFF											
1. Efficiency	115	149	56	19	339	33.9	44.0	[77.9]	16.5	5.6	[22.1]
2. Attitude	192	123	27	2	344	55.8	35.8	[91.6]	7.8	.006	[7.9]
3. Appearance	155	158	17	2	332	46.7	47.6	[94.3]	5.1	.006	[5.2]
Totals	462	430	100	23	1015	45.5	42.3	[87.8]	9.8	2.4	[12.2]
C. BEVERAGE STAFF											
1. Efficiency	170	132	21	6	329	51.7	40.1	[91.8]	6.4	1.8	[8.2]
2. Attitude	182	132	25	3	342	53.2	38.6	[91.8]	7.3	.009	[7.4]
3. Appearance	140	155	33	9	337	41.5	46.0	[87.5]	9.8	2.7	[12.5]
Totals	492	419	79	18	1008	48.8	41.6	[90.4]	7.8	1.8	[9.6]

Overall, combined ratings of Breakfast, Lunch,Dinner and Private Parties show that 87% rate the Food Quality average to above average while 13% feel it is fair to poor.

Within this category Dinner service rates the lowest with 21.3% rating our Dinner service fair to poor.

64.2% rate our Private Dinner Parties as being above average and combining the average and above average ratings a very respectable 89.6% rating is obtained.

Combined ratings of the Food Service Staff with regards to Efficiency, Attitude, and Appearance show 87.8% rate the staff as average to above average and 12.2% feel that these three areas rate Fair to Poor.

Efficiency was rated lowest with 22.1% feeling the service (Particularly luncheon service) is fair (16.5%) to poor (5.6%). Most written comments addressed the fact that luncheon service is too slow.

Attitude and appearance of our food staff rated well with 91.6% rating attitude at average to above average and 94.3% feeling appearance was average to above average. Highest rated of these three areas was attitude at a55.8%above average rating.

These overall ratings indicate that our members perceive their food service staff to have good attitudes and a willingness to please. Service Coordination between the kitchen and Dininr Room Staff at peak periods is still a problem. Management has recently added new experienced and highly referred kitchen staff in hopes of increasing our supervisory capabilities and to back up our Chef. Also added has been a cook with baking and pastry experience thus expanding our menu selections in these two areas.

Beverage Staff was judged on Efficiency, Attitude and Appearance. Overall combined rating showed a 90.4% average and above average rating while 9.6% of the respondents rated the Beverage Service Staff fair (7.8%) to poor (1.8%). The area of concern was Appearance rating which showed that 12.5% felt appearance could be improved. Uniforms for cocktail waitresses, coincidently, have been selected and should be in use within 1 week. We actually were in the planning stages for uniforms prior to the survey and the survey results emphazized the need for improvement. Name tags are also on order for the service staff.

92% of the respondents rated the Beverage staff as average to above average in the areas of Efficiency and Attitude. Here again, the perception of attitude appears to be good.

Functions

The Club Manager has prepared an analysis of food sales by category (copy attached). The conclusion of this analysis is that the regular service, i.e., lunch/dinner service results in a substantial loss before net assessments. On the other hand, there appears to be substantial profits derived from Club parties, private parties, receptions and catering. However, the Club is reaching the point of saturation in turns accomodating special functions and private parties.

From the analysis we recommend that special events, private parties, etc., be encouraged. Also, since there are limited additional private parties, receptions, etc. that can be scheduled, we suggest that the pricing of these functions be increased so as to better reflect the worth of the service and atmosphere inherent in having the function at the Club. This, together with the previous recommendations concerning menu pricing should result in bottom line improvement.

Conclusions

Assuming that no significant improvement in food costs is available and that an improvement in labor costs is impractical for service considerations, some alternative solutions are:

A. Private-party functions

Since private-party functions generate higher average sales per patron than average sales per member, actively encourage club members to hold more private parties and receptions at PGC. Also increase the prices of private parties.

B. Increase non-member sales

Since non-members spend more than members per meal, increase the number of non-member meals served each month. One possible way to encourage increased non-member meals would be to actively encourage club members to bring in more non-members for lunches, dinners, and special functions.

C. Increase dining room assessment per member

One of the main reasons the food service operation is not profitable is that it offers a quiet atmosphere at a very reasonable price. Consequently, it is reasonable that club members pay more for this privilege if other solutions are not adopted.

D. Change pricing structure of menu.

1. Increase prices, as indicated previously. This way, members who use the food service bear more of its support.

2. Change pricing structure based on menu item popularity and relative profit margin.

It is the overall conclusion of the Finance Committee that the recommendations we have set forth above should result in improved profitability of the combined dining room and bar operations. The 1981 budget reflected a $12,055 net income as follows:

Dining room loss	$50,875
Bar Profit	62,930
	$12,055

Based upon 1981 operations to date, it appears that the actual net income will be closer to $20,000 as follows:

Dining room loss	$43,287
Bar profit	64,581
	$21,294

Accordingly, we suggest that the Board of Directors and General Manager undertake a [redacted] program based upon our recommendations that would result in net dining room/bar income of $20,000 in 1982. This program will be monitored and reviewed annually with the ultimate goal being a break-even financial picture for the dining room.

FOOD SALES ANALYSIS

June 1, 1980 through May 31, 1981

	FOOD SALES	OTHER SALES (ROOM RENTALS)	TOTAL SALES FOOD AND OTHER	PERCENT OF TOTAL SALES $503,101	NUMBER OF PEOPLE SERVED (COVERS)	AVERAGE CHECK TOTAL
Regular lunch	$116,881	N/A	$116,881	23.2%	36,597	$ 3.19
Regular dinner	93,601	N/A	93,601	18.6	9,353	10.01
Club special lunches	18,014	N/A	18,014	3.6	3,580	5.03
Club special dinners	52,601	N/A	52,601	10.5	4,814	10.93
P. party lunches	24,111	N/A	24,111	4.8	4,318	5.58
P. party dinners	82,533	N/A	82,533	16.4	5,279	15.63
Receptions	64,496	$24,229	88,725	17.6	10,291	8.62
Catering	7,627	N/A	7,627	1.5	1,016	7.50
A-frame/snack bar	8,588	N/A	8,588	1.7	N/A	-
Misc. charges (Pro-am, etc.)	1,523	N/A	1,523	.3	N/A	-
SPECIAL EVENTS						
1980 Jrs. State Champ.	2,917	N/A	2,917		N/A	-
CWAA Golferoo	1,567	N/A	1,567	1.8	144	10.88
Mgrs.-Directors Dinner	5,624	N/A	5,624		296	19.00
(less misc. adjustments)	(1,211)	N/A	(1,211)		N/A	-
GRAND TOTALS	$478,872	+ $24,229	= $503,101	100.0%	75,688	$ 6.65

COMPARISON

REGULAR SERVICE vs. CLUB PARTIES, PRIVATE PARTIES, RECEPTIONS, CATERING, OTHER

	12 Months Ended May 1981 Regular Service Lunch/Dinner	12 Months Ended May 81 Club Parties Private Parties, Receptions, Catering	TOTAL 12 Months Ended May 81 All Said Categories
INCOME:			
Food sales	$ 210,482	$ 268,390	$ 478,872
Other sales	-	24,229	24,229
Total sales	210,482	292,619	503,101
EXPENSES:			
Labor	$ 184,321	$ 34,096	$ 218,417
Meals	9,906	1,092	10,998
Payroll taxes	22,805	7,523	30,328
Workman's comp.	5,306	2,809	8,115
Blue Cross	5,323	2,599	7,992
Sub total	227,661	48,119	275,780
Food Cost	103,136 (40.0%)	120,076 (44.7%)	223,313 46.6%
Total labor and food expenses	(330,797)	(168,195)	(498,992)
Sub total + (-) before other expenses	(120,315)	+124,424	+ 4,109
Other expenses allocated by percent of people served	(43,117)	(26,992)	(70,109)
Profit (loss) from operations before assessment	(163,432)	+ 97,432	(66,000)
Assessment	N/A	N/A	24,429
Net profit (loss) after assessment			(41,571)

REGULAR SERVICE LABOR ANALYSIS

LABOR AMOUNT BEFORE TAXES AND FRINGE

WEEKLY BASIS - MENU LUNCHES AND DINNERS ONLY

DAY OF WEEK (TYPE OF SERVICE)	KITCHEN LUNCH LABOR	KITCHEN DINNER LABOR	DINING ROOM LUNCH LABOR	DINING ROOM DINNER LABOR	TOTAL DAILY LABOR	AVERAGE DAILY FOOD SALES
TUESDAY	$ 213.00	CLOSED	$ 266.00	CLOSED	$ 439.00	$L= $ 405.00
WEDNESDAY	215.00	$ 199.00	237.00	$ 187.00	838.00	L=442.00 D=511.00 = 953.00
(2-ball buffet)		206.00		178.00	836.00	L=442.00 D=1,210.00 = 1,652.00
THURSDAY	284.00	CLOSED	237.00	CLOSED	521.00	L= 354.00
FRIDAY	215.00	199.00	226.00	194.00	834.00	L=358.00 D=570.00 = 928.00
SATURDAY	220.00	CLOSED	165.00	CLOSED	385.00	295.00
SUNDAY	172.00	181.00	246.00	180.00	779.00	L=415.00 D=656.00 = 1,071.00
(Buffet service)		233.00		187.00	838.00	L=415.00 D=1,141.00 = 1,556.00
MONDAY	CLOSED	CLOSED	CLOSED	CLOSED	CLOSED	CLOSED
	1,319.00	Regular Dinner 579.00	1,337.00	Regular 561.00	Weekly 3,796.00	$4,006.00
WEEKLY TOTALS	$1,319.00	Sunday Buffet 2-balls $ 638.00	$1,337.00	Sunday Buffet 2-balls $ 559.00	$3,853.00	$ 5,190.00
	$1,319.00	Sunday Buffet $ 631.00	$1,337.00	Sunday Buffet $ 568.00	$3,855.00	$ 4,491.00

ANNUAL LABOR COST

LABOR	$DAILY LABOR	X	NUMBER OF DAYS SERVED	=	TOTAL LABOR/DAY/YEAR	REGULAR FOOD SALES
TUESDAY	439	X	50		$ 21,950	$ 20,250
WEDNESDAY REGULAR LUNCH	452	X	52		23,504	22,984
WEDNESDAY REGULAR DINNER	386	X	37		14,282	18,907
WEDNESDAY 2-BALL DINNER	384	X	12		4,608	14,520
THURSDAY	521	X	49		25,529	17,346
FRIDAY REGULAR LUNCH	441	X	52		22,932	18,616
FRIDAY REGULAR DINNER	393	X	45		17,685	25,650
SATURDAY	385	X	52		20,020	15,340
SUNDAY BREAKFAST/LUNCH	418	X	53		22,154	21,095
REGULAR DINNER	361	X	40		14,440	26,240
BUFFET DINNER	420	X	7		2,940	7,987
					$190,044	$210,482*
					LABOR	vs. SALES
ADJUSTED FOR 6 MONTH PAY RAISE					$184,321	

*Adjusted total due to averaging.

LABOR COST PER PERSON SERVED

	Regular Lunch	Regular Dinner	Excess Labor Applied to: Club Parties, Private Parties, Receptions, Catering, Other	Overall 12 Months Ended May 1981
LABOR	$132,013	$52,308	$34,096	$218,417
MEALS	6,474	3,432	1,092	10,998
PAYROLL TAXES	17,175	5,630	7,523	30,328
WORKMAN'S COMP.	3,996	1,310	2,809	8,115
BLUE CROSS (12)	3,652	1,671	2,599	7,922
TOTAL	$163,310	$64,351	$48,119	$275,780
NUMBER SERVED	36,597	9,353	29,738	75,688
LABOR COST PER PERSON SERVED	$ (4.46)	$ (6.90)	$ (1.62)	$ (3.64)
AVERAGE FOOD COST	(1.25)	(4.35)	(4.03)	(2.96)
SUB TOTAL	(5.71)	(11.25)	(5.65)	(6.60)
AVERAGE CHECK AND TOTAL	$ 3.19	$ 10.01	$ 9.84	$ 6.65
NET P (L) PER MEAL BEFORE OTHER EXPENSES	(2.52)	(1.24)	+4.19	+.05

Portland Golf Club
Combined Dining Room and Bar Operations
Nonmember Business (Actual for Source Documents)

	11 Months Ended 9/30/80			Year Ended 9/30/81		
	Dining Room	Bar	Total	Dining Room	Bar	Total
Sales	$68,122	$16,300	$84,422	$85,134	$21,413	$106,547
Variable expenses:						
Food & Liquor	27,249	5,183	32,432	34,054	6,617	40,671
Labor & Other Related Costs	14,540	5,281	19,821	16,868	7,259	24,127
Other	8,362	1,206	9,568	11,853	1,756	13,609
	$50,151	$11,670	$61,821	$62,775	$15,632	$78,407
Excess of Sales over Variable Expenses	$17,971	$ 4,630	$22,601	$22,359	$ 5,781	$28,140
Fixed Expenses	3,153	0 *	3,153	4,666	0 *	4,666
Profit	$14,818	$ 4,630	$19,448	$17,693	$ 5,781	$23,474

*Fixed expenses are included under Dining Room.

EXHIBIT NO. _____

Form **990-T**
Department of the Treasury
Internal Revenue Service

Exempt Organization Business Income Tax Return

(Under Section 511 of the Internal Revenue Code) For calendar year 1984 or other tax year beginning October 1, 1984, and ending September 30, 19 85

OMB No 1545-0687

1984

Name of organization
Portland Golf Club

Address (number and street)
5900 S.W. Scholls Ferry Road

City or town, State, and ZIP code
Portland, Oregon 97225

A Employer identification number (employees' trust see instruction for Block A)
93 : 0256880

B Enter unrelated business activity codes from page 10 of instructions
5800 | 9100 |

C Check box if address changed . . . . . ▶ ☐

D Exempt under section . . . . . ▶ 501 (c) (7)

E Check applicable box . . ▶ ☒ Corporation ☐ Trust ☐ Section 401(a) trust

F Group exemption number (see instructions for Block F) ▶ N/A

If the unrelated trade or business gross income is $10,000 or less, complete only page 1, Part III on page 2, and sign the return.
Complete all applicable parts of the form (except lines 1 through 4) if unrelated trade or business gross income is over $10,0

Taxable Income

1	Unrelated trade or business gross income (state sources ▶ Dividends & Interest)	1	11,418
2	Deductions (complete Parts I and II instead of lines 1, 2, 3 and 4 if you have gross income over $10,000)	2	
3	Unrelated business taxable income before specific deduction (subtract line 2 from line 1)	3	11,418
4	Specific deduction (see instructions)	4	(1,000)
5	Unrelated business taxable income (subtract line 4 from line 3 or enter amount from line 33, page 2)	5	10,418

Tax Computation

Organizations Taxable as Corporations (See Instructions for Tax Computation)

6 (a) Check if you are a member of a controlled group (see sections 1561 and 1563) . . . . . ☐

(b) If checked, see instructions and enter your share of the $25,000 in each taxable income bracket:
(i) $ ____ (ii) $ ____ (iii) $ ____ (iv) $ ____

7	Income tax on amount on line 5, above. Check here ▶ ☐ if alternative tax from Schedule D (Form 1120) is used.	7	1,563

Trusts Taxable at Trust Rates (See Instructions for Tax Computation)

8	Enter the tax from the tax rate schedule in the instructions on the amount on line 5	8	

Total Income Tax

9	(a) Foreign tax credit (corporations attach Form 1118, trusts attach Form 1116)	9(a)			
	(b) Other credits (see instructions)	9(b)			
	(c) General business credit.— Check if from ☐ Form 3800 ☐ Form 3468 ☐ Form 5884 ☐ Form 6478	9(c)			
10	Total (add lines 9(a) through 9(c))			10	0
11	Subtract line 10 from line 7 or line 8			11	1,563
12	Tax from recomputing prior year investment credit (attach Form 4255)			12	
13	Minimum tax on tax preference items (Corporations only– see instructions)			13	
14	Alternative minimum tax (Trusts only–see instructions)			14	
15	Total tax (add lines 11 through 14)			15	1,563
16	Credits and payments:				
	(a) Tax deposited with Form 7004 or Form 2758	16(a)			
	(b) Foreign corporations—Tax paid or withheld at the source (see instructions)	16(b)			
	(c) Credit from regulated investment companies (attach Form 2439)	16(c)			
	(d) Credit for Federal tax on gasoline and special fuels (attach Form 4136)	16(d)	716		
	(e) Other credits and payments (see instructions)	16(e)			
	(f) Total credits and payments (add lines 16(a) through 16(e))			16(f)	716
17	**TAX DUE** (subtract line 16(f) from line 15). See instructions for depositary method of payment ▶			17	847
18	**OVERPAYMENT** (subtract line 15 from line 16(f)) ▶			18	

Please Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▶ Signature of officer | Date | ▶ Title

Paid Preparer's Use Only

Preparer's signature ▶ | Date | Check if self-employed ▶ ☐ | Preparer's social security no.

Firm's name (or yours, if self-employed) and address ▶ Ernst & Whinney
Portland, Oregon

E.I. No. ▶ 34-6565596
ZIP code ▶ 97201

For Paperwork Reduction Act Notice, see page 1 of instructions.

Form **990-T** (1984)

EXHIBIT NO. ____

98

SCHEDULE C—RENT INCOME FROM REAL PROPERTY AND PERSONAL PROPERTY LEASED WITH REAL PROPERTY

(See Instructions for Part I, line 6)

1. Description of property	2. Rent received or accrued	3. Percentage of rent for personal property
N/A		%
		%
		%
		%
		%

4. Complete for any item if the entry in column 3 is more than 50%, or if the rent is based on profit or income		5. Complete for any item if the entry in column 3 is more than 10% but not more than 50%		
(a) Deductions directly connected (Attach schedule)	(b) Income includible (Column 2 minus column 4(a))	(a) Gross income reportable (Column 2 x column 3)	(b) Deductions directly connected with personal property (Attach schedule)	(c) Income includible (Column 5(a) minus column 5(b))
	N/A			

Add columns 4(b) and 5(c) and enter total here and on line 6, Part I, page 2 . . . . .

SCHEDULE E—UNRELATED DEBT-FINANCED INCOME (See Instructions for Part I, line 7)

1. Description of debt-financed property	2. Gross income from or allocable to debt-financed property	3. Deductions directly connected with or allocable to debt-financed property	
		(a) Straight-line depreciation (Attach schedule)	(b) Other deductions (Attach schedule)
1 N/A			

4. Amount of average acquisition indebtedness on or allocable to debt-financed property (Attach schedule)	5. Average adjusted basis of or allocable to debt-financed property (Attach schedule)	6. Percentage which col. 4 is of col. 5	7. Gross income reportable (Column 2 x column 6)	8. Allocable deductions (Column 6 x total of columns 3(a) and 3(b))	9. Net income or (loss) includible (Column 7 minus column 8)
		%			
		%			
		%			
		%			
		%			
2 Total (enter here and on line 7, Part I, page 2)					
3 Total dividends-received deductions included in column 8					

SCHEDULE F—INVESTMENT INCOME OF A SECTION 501(c)(7) OR (9) ORGANIZATION

(See Instructions for Part I, line 8)

1. Description	2. Amount	3. Deductions directly connected (Attach schedule)	4. Net investment income (Column 2 minus column 3)	5. Set-asides (Attach schedule)	6. Balance of investment income (Column 4 minus column 5)
Money Market					
Account-MLPF&S	11,106		11,106		11,106
USNB	312		312		312
Total (enter here and on line 8, Part I, page 2)					11,418

SCHEDULE G—INCOME (ANNUITIES, INTEREST, RENTS AND ROYALTIES) FROM CONTROLLED ORGANIZATIONS

(See Instructions for Part I, line 9)

1. Name and address of controlled organization(s)	2. Gross income from controlled organization(s)	3. Deductions of controlling organization directly connected with column 2 income (Attach schedule)	4. Exempt controlled organizations		
			(a) Unrelated business taxable income	(b) Taxable income computed as though not exempt under sec. 501(a), or the amount in col. (a), whichever is more	(c) Percentage which col. (a) is of col. (b)
N/A					%
					%
					%

5. Nonexempt controlled organizations			6. Gross income reportable (Column 2 x column 4(c) or column 5(c))	7. Allowable deductions (Column 3 x column 4(c) or column 5(c))	8. Net income includible (Column 6 minus column 7)
(a) Excess taxable income	(b) Taxable income, or amount in column (a), whichever is more	(c) Percentage which col. (a) is of col. (b)			
		%			
		%			
		%			
Total (enter here and on line 9, Part I, page 2)					

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Form **4136**

Department of the Treasury
Internal Revenue Service (0)

Computation of Credit for Federal Tax on Gasoline and Special Fuels

▶ Attach this form to your income tax return.

OMB No 1545-0162

1984
25

Name (as shown on your income tax return)
Portland Golf Club

Social security or employer identification number
93-0256880

Type of Use	Gasoline and Gasohol, Diesel Fuel, and Other Special Motor Fuels		
	A. Number of Gallons Used	B. Rate of Tax	C. Multiply Column A by Column B
1 Qualified diesel-powered highway vehicles (See instruction E.)			$
2 Nonhighway:			
a Farm (for farming purposes) (Ground applicators of agricultural substances, see instruction C.1.):			
(i) Gasoline		.09	
(ii) Diesel fuel		.09/.15	$
(iii) Special fuels		.09	
b Commercial fishing vessel (See instructions C.2. and D.2.(b)):			
(i) Gasoline		.09	
(ii) Diesel fuel		.09/.15	$
(iii) Special fuels		.09	
c Off-highway business (specify) Unlicensed off-road vehicles			
(i) Gasoline	7,774	.09	
(ii) Diesel fuel	110	.09/.15	$ 716
(iii) Special fuels		.09	
3 a Intercity, local, and school buses (See instruction C.4.)		.09/.12 *	
b Qualified local buses (See instruction D.2.(c).)		.15	$
4 Gasoline/Alcohol Mixture		.0456/.0566 *	$
5 a Diesel/Alcohol Mixture		.05/.11/.06 *	
b Special Fuels/Alcohol Mixture		.05/.06 *	$
6 Qualified taxicab		.04 *	$
Aviation Fuel			
7 Farm (for farming purposes) (Aerial applicators of agricultural substances, see instruction C.1.)		.12/.14 *	$
8 Aviation (Applies only to commercial or certain helicopter uses as defined in instruction C.7.)		.12/.14 *	$
9 Total income tax credit claimed (add lines 1 through 8) ▶			$ 716

* *Use rate paid or allowable rate if less*

Instructions

(Section references are to the Internal Revenue Code)

Paperwork Reduction Act Notice.—We ask for this information to carry out the Internal Revenue laws of the United States. We need it to ensure that taxpayers are complying with these laws and to allow us to figure and collect the right amount of tax. You are required to give us this information.

Changes You Should Note.

- The credit for tax paid on lubricating oil has been repealed.
- If on January 1, 1985, you owned a qualified diesel-powered highway vehicle, you may be entitled to an income tax credit for 1984.

Refund Instead of Credit.—If you paid excise tax of at least $1,000 ($200 for gasoline/alcohol mixture and $50 for gasoline, diesel fuel, or special fuels used in a qualified taxicab) on any fuel category used in any one of the first three quarters of the tax year, you may file for a refund of the tax instead of claiming a credit for it on Form 4136. To claim the refund, file **Form 843**, Claim, before the end of the quarter following the one for which you are claiming the refund. Show separate computations for a claim on gasoline and special fuels. You may use Form 4136 as a worksheet to show your computations and attach it to the Form 843 you file.

You must claim a credit, rather than a refund, for any tax paid during the fourth quarter, and for any tax under $1,000 ($200 for gasoline/alcohol mixture and $50 for gasoline, diesel fuel, or special fuels used in a qualified taxicab) for any fuel used in the first three quarters. You must also claim the credit rather than a refund, for tax paid on gasoline or special fuels used on a farm for farming purposes.

Do not claim a credit on Form 4136 for any amount that you previously claimed as a refund.

A. Purpose of Form.—File this form if you claim credit for Federal excise tax on gasoline and gasohol, diesel fuel and other special fuels used for certain types of business uses or the credit for diesel-powered highway vehicles.

The credit is figured by multiplying the number of gallons used by the rate of Federal excise tax paid or the allowable rate if lesser.

An individual, estate, trust, or corporation may file this form, but a partnership may not. However, when a partnership files **Form 1065**, it must include a statement showing how many gallons of the fuels are allocated to each partner, the types of use, and the applicable tax rate as shown on this form.

B. Year To Include the Credit Or Refund In Income.—When you claim a credit or refund, you must include it in your gross income to the extent it resulted in a reduction of your income tax. The year in which you include it depends upon your method of accounting. This rule does not apply to the credit claimed on line 1.

1. Cash Method.—If you use the cash method, include the amount of credit in gross income for the tax year in which you file the tax return that claims the credit. If you file an amended return, or if you file a claim for credit or refund (and claim the credit for the tax), include the refund that results from the credit in your gross income for the tax year you receive it.

2. Accrual Method.—If you use the accrual method, figure the amount of the credit or refund due at the close of your tax year. Include it in income, even if you have not filed a claim for refund.

C. What Gasoline to Include.—You may claim credit for Federal excise tax on gasoline or gasohol for farm uses, commercial fishing vessel uses, off-highway business uses, intercity, local, or school bus uses, qualified taxicab use, and commercial or certain helicopter aviation uses.

1. Farm Use.—You may claim a credit for gasoline used for farming in a trade or business farm in the United States in the amount of 9¢ a gallon. (See instruction C. 7. for aviation fuel used for farming.) Such farms include the following: stock, dairy, poultry, fur-bearing animals, truck farms, plantations, ranches, nurseries, ranges, greenhouses, and orchards.

Gasoline is considered used for farming only if the owner, tenant, or operator of the farm uses the gasoline. If gasoline is used for the farming tasks set forth below by anyone else, the owner, tenant, or operator is considered the user of the gasoline. There is an exception to this rule. An aerial or ground applicator of agricultural substances is considered to have used gasoline for farming when performing the farming tasks under the following conditions:

Form **4562**

Department of the Treasury
Internal Revenue Service (O)

Depreciation and Amortization

▶ See separate instructions.
▶ Attach this form to your return.

OMB No 1545-0172

1984
67

Name(s) as shown on return
Portland Golf Club

Identifying number
93-0256880

Business or activity to which this form relates
Section 501(c)(7) Organization

Part I Depreciation

For transportation equipment (e.g. autos), amusement/recreation property, and computer/peripheral equipment placed in service after June 18, 1984, and used 50% or less in a trade or business, the section 179 deduction is not allowed and depreciation must be taken only on line 2(h).

Section A.—Election to expense recovery property (Section 179)

A. Class of property	B. Cost	C. Expense deduction

1 Total (not more than $5,000). (Partnerships or S corporations—see the Schedule K and Schedule K-1 Instructions of Form 1065 or 1120S) . . . . . |

Section B.—Depreciation of recovery property

A. Class of property	B. Date placed in service	C. Cost or other basis	D. Recovery period	E. Method of figuring depreciation	F. Deduction
2 Accelerated Cost Recovery System (ACRS) (see instructions): *For assets placed in service* **ONLY** *during taxable year beginning in 1984*					
(a) 3-year property		9,599	3	ACRS	2,400
(b) 5-year property		297,336	5	ACRS	44,600
(c) 10-year property					
(d) 15-year public utility property					
(e) 15-year real property—low-income housing					
(f) 15-year real property other than low-income housing					
(g) 18-year real property					
(h) Other recovery property				S/L	
				S/L	

3 ACRS deduction for assets placed in service prior to 1984 (see instructions)	129,854

Section C.—Depreciation of nonrecovery property

4 Property subject to section 168(e)(2) election (see instructions)	
5 Class Life Asset Depreciation Range (CLADR) System Depreciation (see instructions)	
6 Other depreciation (see instructions)	95,497

Section D.—Summary

7 Total (Add deductions on lines 1 through 6). Enter here and on the Depreciation line of your return (Partnerships and S corporations—DO NOT include any amounts entered on line 1.)	272,351

Part II Amortization

A. Description of property	B. Date acquired	C. Cost or other basis	D. Code section	E. Amortization period or percentage	F. Amortization for this year

Total. Enter here and on Other Deductions or Other Expenses line of your return . . . . . |

SCHEDULE SUPPORTING FORM 990-T
PORTLAND GOLF CLUB
Year Ended September 30, 1985
#93-0256880

PART I - UNRELATED TRADE OR BUSINESS INCOME

Line 2 - Cost of goods sold:

Salaries	$ 45,713
Food supplies	25,126
Liquor supplies	6,781
Payroll taxes	5,636
Employees' insurance and meals	5,362
Miscellaneous expense	639
Laundry	925
Electricity	2,493
Gas heat	1,172
Repairs and maintenance	3,968
Supplies	6,178
Cleaning	179
Cartage and hauling	267
Menus	131
Gas and oil	597
Flowers and decorations	205
Battery replacement	249
Professional fees	920
Total Cost of Goods Sold	$106,541

90

SCHEDULE SUPPORTING FORM 990-T
PORTLAND GOLF CLUB
Year Ended September 30, 1985
#93-0256880

PART II - DEDUCTIONS NOT TAKEN ELSEWHERE

Line 18 - Interest		
Interest on contract payable to the University of Oregon Health Sciences Center	$	26
Interest on tax liability		213
Total Interest	$	239
Line 19 - Taxes		
Payroll taxes	$	1,237
Property taxes		2,413
Total Taxes	$	3,650
Line 25 - Other Deductions		
Supplies and other	$	1,051
Electricity		1,040
Gas heat		1,410
Water		325
Telephone		269
Flowers and decorations		333
Sundry		573
Travel		196
Dues		94
Directors' and committees' expenses		831
Postage		349
Printing expense and members' bulletins		696
Professional services		511
Data processing		306
Laundry		301
Entertainment and tournaments		1,527
Liability insurance		936
Managers expense		100
Total Other Deductions	$	10,848
Line 30 - Net operating Loss Deduction		
Net operating loss deduction for the year ending:		
10/31/74	$	13,678
10/31/75		11,831
10/31/76		23,302
10/31/77		57,778
10/31/78		39,943
10/31/79		24,133
09/30/80		28,433
09/30/81		69,608
09/30/82		51,505
09/30/83		44,906
09/30/84		53,332
	$	418,449

Schedule Supporting Form 990-T
Portland Golf Club
Year Ended September 30, 1985
#93-0256880

Part II - DEDUCTIONS NOT TAKEN ELSEWHERE

Line 21 - Depreciation

Total Depreciation per Attached Form 4562	$272,351
Percent Allocated to Unrelated Business Income	x.0427
Total Depreciation	$ 11,629

No. 89-530

FILED
MAR 2 1990
JOSEPH F. SPANIOL, JR.
CLERK

In The

Supreme Court of the United States

October Term, 1989

PORTLAND GOLF CLUB,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

BRIEF FOR PETITIONER

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QUESTION PRESENTED

Whether the lower court erred in holding that Petitioner, a tax exempt social club, may properly deduct losses from a nonmember activity only if it undertakes that activity with the intent to profit, where profit means the production of gains in excess of all variable and properly allocated fixed costs.

PARTIES BELOW

Parties before the United States Court of Appeals for the Ninth Circuit were Portland Golf Club as Appellee and the Commissioner of Internal Revenue as Appellant.

Portland Golf Club has no parent company or subsidiaries.

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No. 89-530

In The

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October Term, 1989

PORTLAND GOLF CLUB,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

BRIEF FOR PETITIONER

OPINIONS BELOW

The opinion of the Court of Appeals (J.A. 44-45)[1] is not reported. The opinion of the United States Tax Court (J.A. 25-42) is not officially reported, but is unofficially reported at P-H Memo T.C., par. 88076.

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[1] "J.A. ___" references are to the Joint Appendix filed by the parties.

JURISDICTION

The judgment of the Court of Appeals (J.A. 46.) was entered on June 1, 1989. On August 28, 1989, Justice O'Connor extended the time for filing a writ of certiorari to and including September 29, 1989. The Petition was filed on September 28, 1989, and was granted on January 16, 1990. (J.A. 47.) The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTES INVOLVED

The relevant portions of Sections 511 and 512 of the Internal Revenue Code of 1954 (26 U.S.C.) are set out in a statutory appendix, App. A, *infra*.

STATEMENT

1. Petitioner is a nonprofit Oregon corporation exempt from tax pursuant to Section 501(c)(7) of the Code.[2] (J.A. 15, 26.) Since 1914, Petitioner has owned and operated a private club, including a golf course, restaurant, bar, swimming pool and tennis courts, for the benefit of its members, their guests and nonmembers. (J.A. 16, 26.)

During the fiscal years 1980 and 1981 in issue, Petitioner derived the vast majority of its income from membership dues and other fees paid by members for goods and services provided to the members and their guests. (J.A. 36.) Members were allowed to sponsor guests, friends, and organizations to use Petitioner's facilities

[2] "Code" references are to the Internal Revenue Code of 1954.

and services for private parties, receptions or catering, and such activities generally generated unrelated business income. (J.A. 19, 27.) In addition, Petitioner followed prudent business standards by retaining funds for improvements and contingencies in the form of short-term investments. (J.A. 17, 27, 31-32.) The income earned on these investments was also unrelated business income. (J.A. 17.) The total income earned from sales of food and beverages to nonmembers, as well as from investments, constituted Petitioner's total gross unrelated business taxable income. (J.A. 17, 36.)

In providing food and beverages to nonmembers, Petitioner incurred two types of expenses: (i) variable expenses (those which vary depending on the amount of food and services provided), such as food and beverage costs, payroll, and other costs; and (ii) fixed overhead (facilities and personnel) which was used for both exempt function and nonmember purposes. (J.A. 17, 27, 29.) In preparing its tax returns, Petitioner consistently deducted all of the variable expenses related solely to providing goods and services to nonmembers; it also deducted an allocable portion of the fixed overhead expenses attributable to the facilities and personnel used for both exempt function purposes and non-exempt function purposes, in accordance with Proposed Treasury Regulation Section 1.512(a)-3(b)(5).[3] (J.A. 17, 27.) These fixed overhead expenses consisted of those which were approximately the same amount regardless of the amount of food

[3] This proposed regulation was issued on May 13, 1971 (36 Fed. Reg. 8809), and was withdrawn on January 29, 1987 (52 Fed. Reg. 2724).

and related services provided to nonmembers, such as taxes, depreciation, utilities and salaries. (J.A. 17, 27.)

Petitioner's prices for sales of food and beverages to nonmembers were in excess of the prices of food and beverages served to members (J.A. 28.) It priced the sale of food and beverages to nonmembers so that the cost of food was about 30 to 33 percent of the selling price of the meal (J.A. 28.) The prices of food and beverages at nonmember activities was set by the Board of Directors and the club management at an amount intended to result in a profit to the club over the variable (direct) costs associated with the activity (J.A. 31.) In addition, these activities were promoted with the intent to attract additional members to the club and thereby to generate additional income from initiation fees, and to sharpen the skills of the chef and his staff (J.A. 31.)

Petitioner's activities were run in a businesslike manner, and it kept complete and accurate books and records of its activities. (J.A. 30.) Its Board of Directors and Finance Committee closely supervised the food and beverages operations, and in 1981 conducted a study showing that the income from sales of food and beverages to nonmembers substantially exceeded all variable costs plus a portion of the dual use fixed overhead costs, allocated based upon the number of nonmembers served divided by the total number of people served. (J.A. 30-31, 78-79, 81-84.) One of the conclusions in this report was that since nonmembers spent more per meal than members, the club should increase the number of nonmember meals served each month and encourage club members to bring in nonmembers for lunches, dinners, and special functions (J.A. 30-31, 78.)

Petitioner's day-to-day operations were supervised by a full-time manager with substantial club management experience. (J.A. 30, 31.) He held degrees in hotel and restaurant administration and recreation administration; he had previously been employed by hotels and other private clubs; and he was an officer of various club and restaurant associations. (J.A. 30, 31.)

Petitioner was concerned about the profitability of private party income, substantially all of which was nonmember business. (J.A. 31; RT 27-35.)[4] It conducted numerous reviews and studies of the profitability of private party income. (J.A. 30-31, 73-85; J. Exs. 7-G, 8-H, 9-I, 10-J, 11-K, 16-P, 17-Q.)[5] Had Petitioner chosen to report fixed overhead expenses for nonmember activities using an allocation method employing square foot and hours of actual use of facilities for the nonmember activities,[6] it would have had net taxable income for income tax purposes from the sale of food and beverages to nonmembers of $19,448 in fiscal 1980 and $23,474 in fiscal 1981. (J.A. 29.)[7]

---

[4] "RT ___" references are to the trauscript of the Tax Court trial, which was not reproduced in the Joint Appendix.

[5] "J. Ex ___" reference are to the joint exhibits which were part of the stipulation of facts in the Tax Court, and which are not reproduced in the Joint Appendix.

[6] This "actual use" allocation method has been adopted by the Government as an example of a reasonable allocation method in the 1980 and 1982 editions of Exempt Organizations Continuing Professional Technical Instruction Programs issued by the Exempt Organizations division of the I.R.S. National Office. This method was also found to be reasonable by the court of appeals in *Rensselaer Polytechnic Institute v. Commissioner*, 732 F.2d 1058 (2d Cir. 1984).

[7] A schedule showing how net income was computed using such an allocation method is reproduced at Appendix B, *infra*.

Since 1975, through and including the years at issue, Petitioner, in its tax returns, has used another allocation formula in order to compute the amount of fixed overhead allocated to and deducted from its unrelated business taxable income. This allocation method was based on the ratio that nonmember sales bore to total sales, and was stipulated by the parties to be reasonable. (J.A. 17, 27, 28.) The parties further stipulated that for the years at issue, an allocable portion of Petitioner's fixed overhead costs was properly attributable and directly connected to the generation of nonmember income. (J.A. 18, 28.)

Using this "gross-to-gross" allocation formula, Petitioner's unrelated business tax return reported losses on nonmember food and beverage sales for fiscal 1980 and 1981. Petitioner offset these losses against its taxable investment income, and reported a net loss in each year. (J.A. 32.) The Commissioner refused to allow the loss deductions, and asserted tax deficiencies of $1,828 for fiscal 1980 and $3,470 for fiscal 1981. (J.A. 32, 50-51.)

2. In the Tax Court, the Government conceded that Petitioner properly allocated its nonmember deductions to nonmember gross income, and that such deductions satisfied all requirements of Title 1 of the Code save one. But the Government maintained that a club must satisfy the "trade or business" requirement of Section 162 and correlative statutes by establishing it had a profit motive, by reporting an excess of gross income over deductions on its unrelated business tax return. Since Petitioner did not earn a tax profit computed under this formula, the Government refused to allow it to deduct the reported tax loss on its nonmember food/beverage activity to offset its investment income.

Petitioner primarily argued that Section 512(a)(3), which defines unrelated business income and deductions for exempt social clubs, does not, as a matter of law, require a profit motive to exist as a prerequisite to deductions. Alternatively, Petitioner argued that, on the facts presented, it had the appropriate profit motive as defined by settled case law.

The Tax Court did not pass on Petitioner's legal argument, but instead applied the normal profit motive tests which it usually applies in tax shelter, sale-lease-back, hobby, and other cases involving trade-or-business deductions. It reviewed all the facts and circumstances, including the profit statistics described above, and held that Petitioner had a profit motive for its sales to nonmembers and was entitled to deduct all its directly connected expenses. It relied in part on the fact that Petitioner earned a profit when it computed its nonmember food/beverage income using other permissible allocation methods, although it had continuous losses under the permissible allocation method used on the tax return. (J.A. 25-42.) In so holding, the Tax Court relied on its prior unanimous reviewed opinion in *North Ridge Country Club v. Commissioner*, 89 T.C. 563 (1987). (J.A. 37-42.)

3. The Court of Appeals reversed (J.A. 44-45), in a rationale fully explicated in *North Ridge Country Club v. Commissioner*, 877 F.2d 750 (9th Cir. 1989), which had similar facts and was argued and decided with the instant case. The court rejected the reasoning of the Sixth Circuit in *Cleveland Athletic Club v. United States*, 779 F.2d 1160 (6th Cir. 1985), which held that Section 512(a)(3)(A) did not incorporate the "trade or business" and profit motive requirements of Section 512(a)(1). The Ninth Circuit held that Section 512(a)(3)(A) implicitly contains a "trade or

business" and profit motive requirement for a deduction, and disregarded the Sixth Circuit's position that Congress deliberately included these requirements in Section 512(a)(1) which governs deductions of other exempt organizations, but excluded those terms from Section 512(a)(3) which authorizes the corollary deductions for exempt social clubs. In the instant case, the Ninth Circuit opinion (J.A. 44-45) incorporated by reference its interpretation of Section 512(a)(3)(A) in the *North Ridge* opinion.

The Ninth Circuit rejected, however, the Government's proposed "profit" definition – that profit means taxable income as reported on a taxpayer's income tax return. Instead, the court adopted its own definition of profit motive – that it requires "an intent of producing gains in excess of direct costs (costs related to the nonmember activity) and indirect costs (overhead and other fixed expenses)", with costs computed under any reasonable method of allocation. The court therefore remanded the case to the Tax Court, to allow Petitioner to prove that it intended to earn a profit using the "actual use" allocation method, as contrasted with the "gross to gross" allocation method used on the return. (J.A. 44-45.)

SUMMARY OF ARGUMENT

1. (a) This case involves the correct method for determining the unrelated business taxable income of membership social clubs. These clubs are tax-exempt in name only, and pay tax as provided in Section 511(a) of the Internal Revenue Code on their net unrelated business income as determined under the definition set forth in Code Section 512(a)(3)(A). The issue in this case is whether a social club, exempt under Section 501(c)(7),

may deduct expenses in excess of its gross income on one taxable unrelated business activity (here nonmember food and beverage business), and use the loss to offset net income from another taxable unrelated business activity (here net investment income).

When social clubs were first made subject to the unrelated business tax in 1969, Congress provided two different computational formulas. Section 512(a)(1) is applicable to most exempt organizations, and Section 512(a)(3)(A) is applicable only to social clubs and voluntary employees' beneficiary associations. Section 512(a)(1) provides that an activity must satisfy the "trade or business" test of Section 513, and other requirements, in order to be an unrelated business subject to tax. All other income is exempt, and expenses directly connected to such income are nondeductible. Section 513 specifically requires that an unrelated business must satisfy the profit motive requirement of Section 162. In general, Sections 512(a)(1) and 513 define unrelated business income and deductions narrowly, to reflect Congress' desire to exempt broadly the activities of public benefit organizations to which the statutes apply.

Section 512(a)(3)(A) is structured completely differently. The statute defines "unrelated business income" as *all* gross income, except a narrowly defined class of "exempt function income." In general, only dues, fees and other similar payments by members constitute exempt function income. The definition of allowable deductions exactly tracks the corresponding gross income: all expenses directly connected to gross income are deductible, except those expenses directly connected to exempt function income. Congress' purpose was to define narrowly

the exempt income and the exempt function expenses, in view of the more limited exempt purposes of social clubs.

The parties agree that all of the expenses in issue were "directly connected" with Petitioner's unrelated business "gross income" within the meaning of the Section 512(a)(3)(A), and that they are the types of corporate expenses allowed as deductions by Code Section 162 and correlative expense deduction statutes. But the Government contends that some activities generating expenses do not satisfy the "profit motivation" test under Section 162, and therefore are not deductible. Petitioner contends that Section 512(a)(3)(A) defines the activity producing the expenses here as an unrelated "business", and that there is no need to apply the profit motive test to redetermine if the activity is a "business".

The critical flaw in the Government's position is its assumption that Section 162 cannot support a deduction unless the taxpayer's activity meets a separate test that it was profit motivated. Code Section 162 does not itself contain a term requiring a "profit motive"; profit motive only is relevant to determine if an activity satisfies the term "trade or business" in Section 162. While a profit motive is generally necessary for an activity to rise to the level of a trade or business, that is not always necessary.

Congress in Section 512(a)(3)(A) deliberately fashioned a special definition for the unrelated "business" activities of an exempt social club which encompassed a broad group of activities, many of which do not constitute a "trade or business" as that term is used in Section 162. Congress created this special definition for unrelated business activities of an exempt social club in

order to subject these activities to tax. Through this special definition, Congress declared that the income from these activities was unrelated *business* income; and that the expenses directly connected to these activities were unrelated *business* expenses. Once Congress defined that activity as unrelated *business* activity, the expenses directly connected to these activities become expenses incurred in carrying on a trade or *business*. There is no need to apply the profit motive test to determine if the activity is a trade or business.

The legislative history of Section 512(a)(3) flatly rejects the Government's present trade or business theory. The Treasury Department in proposing the statute stated that all "deductions would be allowable if directly connected with an activity generating income subject to tax, *rather than only if directly connected with an unrelated trade or business* * * * ." The Committee Reports state that "all income", other than member income, "would be *treated* and taxed as business income."

The Government's position also contradicts the plain terms of Section 512(a)(3)(A). The statute requires a computation of all of the "deductions allowed by this chapter which are directly connected with the production of the gross income." This computation assumes that some expenses are both "allowed by this chapter" and "directly connected with" exempt functions. A profit motive test contradicts this assumption, because exempt functions are seldom profit motivated.

(b) The Sixth Circuit in *Cleveland Athletic Club v. United States*, 779 F.2d 1160 (1985), endorsed Petitioner's rationale set forth above, emphasizing that Section 512(a)(3) provided its own sui generis computational formula, which expressly excluded the "profit motive" requirement. However, the case did not give clubs carte blanche in deducting expenses. It recognized Congress' intent to preclude deduction of expenses related to all exempt (member) function activities against income from unrelated business activities. The Court did this by recognizing that even nonprofit organizations may not deduct personal or hobby expenditures. Accordingly, it ruled that directly connected nonmember expenses would only be deductible if incurred in connection with an activity producing "economic gain"; hobby and other personal expenses of members would not be deductible even if camouflaged as from nonmember activities.

This requirement is not a new test to see if an expense directly connected to an unrelated business activity is deductible, but rather goes to the heart of whether the activity is an unrelated business activity or an exempt activity. If an activity is priced so that the gross income does not exceed the variable expenses (expenses which would not be incurred but for the activity), the activity is not being conducted for an economic gain and is at least partially paid for by the members out of their dues. In that event, the members must be benefiting from this policy in some way, and the activity is really an exempt activity, not an unrelated business activity. If it is an exempt activity, the expenses are not deductible against unrelated business income.

Here, it is undisputed that Petitioner always charged prices to nonmembers which far exceeded its variable

costs, so the Sixth Circuit's formula, including its guard against member expenses being deductible against unrelated business income, would require reversal of the Ninth Circuit's decision below.

(c) The Government's proposed incorporation into Section 512(a)(3) of the "profit motive" requirement to determine if there is a Section 162 trade or business conflicts with decisions of this Court holding that there are no uniform definitions of the terms "trade" or "business" applicable throughout the Internal Revenue Code, and that the terms must be adapted to meet the purposes of the particular statute. The Government's position also conflicts with decisions holding that when Congress has artificially treated activities as trades or businesses by statutory decree, as Congress has done in Section 512(a)(3)(A) here, they are not reexamined to determine if there is a profit motive to establish a business expense.

2. The Tax Court did not address the arguments above regarding whether a profit motive test was incorporated into Section 512(a)(3)(A). It held for Petitioner on the alternative basis that it had a profit motive and was carrying on a trade or business under all the facts and circumstances. The court correctly applied the traditional profit motive standard which it has long used in dozens of "trade or business" cases. In accord with the consistent rulings of this Court, such as *Commissioner v. Groetzinger*, 107 S.Ct. 980 (1987), the Tax Court analyzed all of the facts, such as use of standard business techniques, employment of trained and experienced managers, devotion of time and resources of directors and management to planning and operations, charging of competitive prices,

and intent and efforts to earn an economic profit, and properly found that Petitioner had a profit motive.

The Government agreed with most of the factors applied by the Tax Court, and that Petitioner satisfied the profit motive test which the Tax Court applied. However, the Government insists that the Tax Court's test is legally wrong, on the basis that "economic profit" is the wrong definition of profit. Under the Tax Court's many decisions, "economic profit" will vary somewhat according to the facts and circumstances, but often means cash flow – *viz.*, an excess of gross receipts over variable costs. By contrast, the Government argued that profit always means "tax profit" – an intent to earn gross income in excess of lawfully deductible expenses as determined under the Internal Revenue Code.

The Government's rigid computational approach would wreak havoc with the administration of the most important expenses deduction provisions in the Code – Sections 162 (trade or business expenses), 165 (trade or business losses), and 167 (trade or business depreciation). Taxation of corporations and other businesses would be revolutionized, since many such entities have continuing *tax* losses, but earn substantial economic profits. Many large corporations have claimed tax losses for several consecutive years, while reporting billions of dollars in profits to their shareholders and the SEC for the exact same period. In response to this perceived abuse, Congress in 1986 acknowledged that the normal income tax rules did not always tax real economic profits, and imposed the alternative minimum tax on such economic profits. Such legislation would not have been necessary if the I.R.S. could simply disallow tax deductions which

continually exceeded gross income as being incurred without an intent to make a profit.

Moreover, the voluminous caselaw and legislation on tax shelters, including the complex passive loss rules enacted in 1986, would become moot because many tax shelters by definition have continuous *tax* losses; now they are only required to demonstrate an intent to earn an "economic profit" in order to obtain deductions under Sections 162, 165, and 167.

The Government's theory that "profit" for profit motive purposes equals taxable income is contrary to the overwhelming weight of the cases, Treasury Regulations, legislative history, accounting literature, and law review authors. It even conflicts with the only published ruling under Section 512(a)(3), which states that profit equals gross income less "costs of sales."[8]

Congress intended to tax the taxable side of a social club like a regular taxable corporation conducting a business. Section 162 does not prevent a taxable business from offsetting losses on one taxable activity (e.g., a department store restaurant) against profits on another taxable activity (e.g., the department store's jewelry department). The Government's position on club losses is discriminatory and unfair; "heads I win, tails you lose."

For these reasons, we submit that the Tax Court's decision should be affirmed, and that the Ninth Circuit's opinion should be reversed.

3. The Ninth Circuit below developed its own unique meaning of profit motive, defining profit as "the production of gains in an excess of all direct and indirect

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[8] Revenue Ruling 81-69, 1981-1 C.B. 351.

costs." *North Ridge Country Club v. Commissioner*, 877 F.2d 750 (9th Cir. 1989). In this case below, the Ninth Circuit reversed the Tax Court's decision because, in the Appeal Court's view, the trial court had erred by using the wrong standard of "profit", but remanded the case to the Tax Court for a determination whether Portland Golf Club had a profit motive as required under *North Ridge*, "[b]ecause Portland Golf Club could have reported gains in excess of direct and indirect costs, but did not do so, relying on a method of allocation stipulated to be reasonable by the Commissioner." We believe Petitioner here also satisfies the *North Ridge* standard, but we believe the Tax Court's test is preferable.

ARGUMENT

I

CODE SECTION 512(a)(3) DOES NOT REQUIRE EACH UNRELATED BUSINESS ACTIVITY OF A SOCIAL CLUB TO EARN TAXABLE INCOME IN ORDER TO DEDUCT ALL EXPENSES DIRECTLY CONNECTED WITH SUCH ACTIVITY

A. The Language and Legislative History of Section 512(a)(3) Eliminate the Trade-or-Business and Profit-Motive Requirements

Petitioner is a social club which is nominally tax exempt under Section 501(c)(7) of the Internal Revenue Code, Appendix A, *infra*. The taxation of Section 501(c)(7) clubs is governed by Code Section 512(a)(3), Appendix A, *infra*. To fully understand the issues of this case, one must have an understanding of the language and legislative history of the statutes relating to tax exempt status of certain organizations, and the exceptions pursuant to

which the net income of some of such exempt organizations' activities may be subject to tax.

The Congressional purpose in adopting Code Sections 401 and 501, providing for exemption from taxation of certain organizations, was twofold[9]:

1. To promote certain publicly beneficial activities by removing from them the burden of taxation; and
2. To allow persons to conduct certain mutually beneficial activities as a group rather than individually, without the added burden of a group level tax.

Prior to 1969, the unrelated business tax did not apply to exempt social clubs and voluntary employees beneficiary associations. When Congress extended the tax to these organizations in 1969, it established separate unrelated business tax computation provisions: Section 512(a)(1) was designed to apply to what were deemed to be organizations whose exemptions were based on publicly beneficial purposes; Section 512(a)(3) was designed for organizations whose exemptions were based on mutual benefit.

Section 512(a)(1), Appendix A, *infra*, sets forth a *general* definition of "unrelated business taxable income" which is not applicable to social clubs.[10] This *general*

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[9] See J. Desiderio and S. Taylor, *Planning Tax-Exempt Organizations*, § 4.03 (1986).

[10] Section 512(a)(1) provides as follows:

> *Except as otherwise provided in this subsection*, the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated *trade or business* (as defined in Section 513) regularly carried on by it, less the deductions

(Continued on following page)

definition explicitly requires an activity to be an "unrelated trade or business (as defined in section 513) regularly carried on by it", in order for income and deductions directly connected to such activity to be includable in the unrelated business category and subject to tax.

The entire thrust of Sections 512(a)(1) and 513 is to define narrowly the activities which constitute taxable "unrelated business" activities; everything remaining constitutes exempt activities not subject to the tax. This corresponds to Congress' general purpose for the unrelated business income tax: to eliminate the unfair advantage of tax exemption only when the exempt organization directly competes with a taxable organization in an activity which is not substantially related to its exempt purposes. All other activity is intended to be exempt from tax because it is used to help promote the publicly beneficial purpose of the exemption. Once an activity is determined not to be an unrelated business activity, it is not reexamined to see if it directly promotes the exempt purpose. If such an examination were to be conducted, many activities would shift between being an exempt activity, if tested by the unrelated business standard, and an unrelated business activity, when tested by the exempt standard. This shifting occurs because a particular activity may not clearly meet either standard.

Code Section 513 defines a "trade or business" for purposes of Section 512(a)(1); it does so by incorporating

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allowed by this chapter which are directly connected with the carrying on of such *trade or business*, both computed with the modifications provided in subsection (b). (Emphasis added).

the requirements of a trade or business as outlined by the cases dealing with that question under Section 162, including the requirement of a profit motive. The definition is then further refined by specific statutory provisions which either include an activity or exclude an activity from the trade or business category.

If an activity conducted by an exempt organization governed by Section 512(a)(1) lacks a profit motive or any other requirement of a trade or business under Section 513, it does not meet the Section 512(a)(1) requirement that it be a trade or business, and it can not be an unrelated business activity. If it is not an unrelated business activity under Section 512(a)(1), it is by definition an exempt activity not subject to tax. If an activity is an exempt activity, the expenses from such activity may not be used to offset net income from unrelated business activities. *Iowa State University of Science and Technology v. United States*, 500 F.2d 508 (Ct. Cl. 1974); *Ye Mystic Krewe of Gasparilla v. Commissioner*, 80 T.C. 757 (1983).

Congress in Section 512(a)(3)(A)[11] adopted an entirely different approach. This statute is a special provision applicable (during the years at issue) only to social clubs

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[11] Section 512(a)(3)(A) provides as follows:

In the case of an organization described in paragraph (7), (9), (17), or (20) of section 501(c), the term "unrelated business taxable income" means the *gross income* (excluding any exempt function income), less the deductions allowed by this chapter which are directly connected with the production of the *gross income* (excluding exempt function income), both computed with the modifications provided in paragraphs (6), (10), (11), and (12) of subsection (b). (Emphasis added).

exempt under Code Section 501(c)(7), and voluntary employees' beneficiary associations exempt under Section 501(c)(9). Unlike the general rule of Section 512(a)(1), Section 512(a)(3)(A) defines "unrelated business taxable income" broadly – it is *all* gross income, except exempt function income. The statute defines narrowly the category of exempt activity, thereby furthering the Congressional intent to allow a tax exemption to social clubs only for activities directly connected to their exempt function. All other activities are subject to tax in the same manner as any taxable business is taxed. Just as some activities in the exempt category in Section 512(a)(1) would not meet an external test of exempt activities, so not all the activities which are categorized in Section 512(a)(3)(A) as unrelated business activities meet an external test of a trade or business. Congress did not intend that these activities should meet some external "business" test.

The plain and ordinary meaning of the language of Section 512(a)(3)(A) is reinforced by its legislative history. Section 512(a)(3) resulted from a proposal by the Treasury Department. In explanation of its proposal, the Treasury Department stated that the "trade or business" concept has no place in Section 512(a)(3):[12]

> Thus, under the proposal, *all income*, other than that from members in exchange for exempt function facilities, would be included in gross income, *whether or not the activities generating*

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[12] *Technical Explanation of Treasury Tax Reform Proposals, Hearings on the Subject of Tax Reform Before the Comm. on Ways and Means*, 91st Cong., 1st Sess., Part 14, at 5059, 5139-5140 (April 22, 1969) (emphasis added). Accord, Department of the Treasury, *Tax Reform Studies and Proposals* (House Ways & Means Comm. & Senate Finance Comm. Jt. Pub. Feb. 5, 1969), Pt. 3, at 324.

> *the income were sufficient to meet the requirements of a "trade or business* regularly carried on" generally applicable under the unrelated business income tax.

The Treasury Department's explanation reiterated this position at a later point:[13]

> [C]onsistent with the elimination of the "trade or business regularly carried on" tests, deductions would be allowable if directly connected with *an activity generating income* subject to tax, rather than only if directly connected with an unrelated trade or business regularly carried on.

The House Ways and Means Committee report stated that under Section 512(a)(3), "all income other than that derived from rendering services to the members * * * *would be treated and taxed as business income.*" H.R. Rep. No. 413, 91st Cong., 1st Sess. (Pt. 1) 47 (1969-3 C.B. 200, 231) (emphasis added).

B. Since Section 512(a)(3)(A) Deems Unrelated Activities To Be "Business" in Character, the Profit Motive Prerequisite for a Section 162 "Business" Is Irrelevant

Section 512(a)(3)(A) of the Code defines "unrelated business taxable income" of a social club as "the gross income (excluding any exempt function income), less the deductions allowed by this chapter which are directly connected with the production of gross income (excluding exempt function income)." This statute establishes a two prong test for the deduction of expenses in determining unrelated business taxable income: (1) the expenses must be of a kind which is allowed as a deduction to a

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[13] Technical Explanation, *supra* note 11 at 5141 (emphasis in original); *Tax Reform Studies and Proposals, supra* note 11, at 325.

business under Chapter 1 of the Internal Revenue Code; and (2) the expense must be directly connected with the production of income by an unrelated business activity. There is no question that all the expenses taken by Petitioner as deductions in determining its unrelated business taxable income were directly connected to the production of such income. The Government has stipulated to this fact. (J.A. 18.)

The issue in dispute is the interpretation of the phrase "less the deductions allowed by this chapter." Petitioner is a corporation, and so only deductions available to a corporation are "allowed by this chapter." The activities conducted by Petitioner which give rise to the expenses are by definition unrelated *business* activities, so deductions allowed in the conduct of a business are allowed by this chapter. Expenses which are allowed as deductions only to individuals or which are never allowable are not "deductions allowed by this chapter," but no expenses of that kind are in issue here.

For a deduction to be allowed by this chapter as required by Section 512(a)(3)(A), the Government would take the position that activities of a social club which are categorized as unrelated business activities must be subjected to a reexamination to determine if they are carried on for a profit and therefore constitute a trade or business as defined by caselaw interpreting Section 162. The critical flaw in the Government's analysis comes from a misinterpretation of how the profit motive test is used in conjunction with Section 162. Code Section 162 allows as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. The profit motive test is not a separate Section 162 statutory term; rather, it is used to determine

whether the activity which produced the expense satisfies the "trade or business" term. If the activity is a trade or business, the expense may be deductible, if it also meets the other statutory terms of Section 162. If the activity is not a trade or business, then the expense is not even tested under the remainder of Section 162.

Generally a profit motive is a necessary factor in determining whether an activity is a trade or business. This is so because most activities could be a "trade or business", or they could be a hobby or other personal activity, depending on all the facts and circumstances surrounding the pursuit of the activity. However, there are some activities which Congress has singled out and defined as business activities. See *Commissioner v. Groetzinger*, 107 S.Ct. 980, 983 fn. 6 (1987). The unrelated trade or business of an exempt organization taxed under Section 512(a)(3) is one example. Government service is another example of an activity that Congress has defined as a business activity. Code Section 7701(26). See *Frank v. United States*, 577 F.2d 93 (9th Cir. 1978). Where Congress has defined an activity as a "business," there is no need to test the activity further for profit motivation.

C. The Plain Meaning of Section 512(a)(3)(A) Provides a Computational Formula for Unrelated Business Taxable Income which Precludes the Application of a Profit Motive Test

A closer analysis and comparison of the language and computational structure of Sections 512(a)(1) and 512(a)(3)(A), respectively, demonstrates that Section

512(a)(1) requires income and deductions to satisfy Section 162 trade or business and profit motive requirements, while Section 512(a)(3)(A) eliminates such requirements.

Section 512(a)(1) provides that unrelated business income includes only the gross income derived from "any unrelated trade or business (as defined in Section 513)." By contrast, Section 512(a)(3)(A) defines unrelated business income as the club's entire "gross income". The only exclusion is "exempt function income", which is defined in Section 512(a)(3)(B) to mean the "gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members or their dependents or guests goods, facilities or services in furtherance of the purposes constituting the basis for exemption of the organization to which such income is paid." This concept of unrelated business income means that only the dues, fees and receipts for goods, facilities or services received from a club's members are excluded from gross income for purposes of computing the club's unrelated business taxable income.[13] It follows that all other gross income – including all investment income, and all receipts for goods, facilities or services paid by non-members – are included in gross income for purposes of computing Petitioner's unrelated business taxable income. The concept of a profit motivated "trade or business" is totally at odds with this Section 512(a)(3) definition of unrelated business gross income.

The difference in scope between Section 512(a)(1) and Section 512(a)(3)(A) is further reflected in their respective

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[13] See Proposed Regulation § 1.512(a)-3, which provides that all items of gross income are added together, and then member income is excluded.

provisions governing deductions. As explained above, Section 512(a)(1) requires a Section 513-defined trade or business. By contrast, to determine deductible expenses, Section 512(a)(3)(A) starts with all of the club's expenses (both exempt and unrelated) which are "allowed by this chapter"[14] to be deductible. The statute includes expenses which are "directly connected" with exempt (member) revenues and those "directly connected" with unrelated (nonmember) revenues. From the total of such "directly connected" expenses, Section 512(a)(3)(A) requires the club to exclude the expenses directly connected with "exempt function income"; the remainder is the amount of tax-deductible expenses.[15]

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[14] The reference here is to Chapter 1 of the Code, which covers Sections 1 through 1399.

[15] The language of Section 512(a)(3) is fundamentally a description of an arithmetic formula, designed to separate exempt and unrelated business revenues and expenses. The formula may be represented mathematically by three successive computations as follows:

(i)		Total gross income
	minus:	exempt function income
	equals:	Unrelated gross income
(ii)		"Deductions allowed by this chapter * * * directly connected with gross income"
	minus:	"Deductions allowed by this chapter * * * directly connected with * * * exempt function income"
	equals:	Total deductions allowed
(iii)		Unrelated gross income
	minus:	Total deductions allowed
	equals:	Unrelated business taxable income

It is apparent that the plain statutory terms of Section 512(a)(3) leave no room for any trade or business requirement for deductions. The Government's position is that the phrase "allowed by this chapter" requires a profit motive test to be applied. However, there is no point in the Section 512(a)(3)(A) calculation when the unrelated activity and its directly connected expenses are segregated from exempt function expenses so that the profit motive test could be applied. The statutory mathematical formula becomes impracticable if the trade-or-business and profit-motive requirements are imposed.[16]

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[16] See Proposed Treasury Regulation § 1.512(a)-3(a)(2), which provides that all the club's directly connected deductions are to be added together, and then the deductions directly connected with exempt functions are to be excluded. Since all directly connected expenses constitute the starting point for deductions, Congress could not have intended to apply a trade-or-business or for-profit requirement, because member functions would typically not be a trade or business and would not be profit motivated.

In the instant case, deductions for fixed expenses were computed using *all* Petitioner's directly connected expenses as a starting point, and from this amount then deriving the fixed nonmember expenses through an allocation formula:

$$\text{fixed expenses directly connected to all gross income} \times \frac{\text{nonmember gross income}}{\text{gross income}} = \text{fixed expenses directly connected to nonmember income}$$

This allocation was stipulated to be correct by the Government. (J.A. 17.) The formula would be impossible to implement if "fixed expenses directly connected to all gross income" had to satisfy a trade or business or profit motivation requirement.

D. The Sixth Circuit's "Economic Gain" Test Correctly Follows the Language of Section 512(a)(3)

The Sixth Circuit in *Cleveland Athletic Club v. United States*, 779 F.2d 1160 (1985), agreed with the statutory analysis set forth above, to the effect that the Section 162 profit motive requirement was not included by the terms of Section 512(a)(3)(A). It emphasized that the Section 512(a)(3)(A) terms included all income (not just trade or business income) in "gross income" subject to tax, and reasoned that it would be unfair to limit deductions to expenses directly connected to gross income which constituted a trade or business as that term is narrowly defined for purposes of Section 162. The Court also recognized, however, that Congress had enacted Section 512(a)(3)(A) to prevent members from taking deductions for their own recreational expenses against taxable unrelated business income, and concluded that a club's unrelated business activity must have a purpose of "economic gain," and not be primarily member hobby or recreational activities camouflaged by nonmember formalities.

Code Section 512(a)(3)(B) defines exempt function income as payments made by members for goods, facilities or services provided to the members, their dependents or guests in connection with social or recreational activities. If this statute were to be read too literally, an exempt activity could be cateogrized as an unrelated business activity, if nonmembers paid any portion of the cost of the activity. For example, a club's members could hold a banquet for their nonmember friends, charge the nonmembers a nominal fee, and then attempt to deduct the directly connected expenses from other unrelated taxable gross income.

We believe that the economic gain test accords with the words of the statute, while furthering the Congressional intent. One Congressional purpose in enacting Section 512(a)(3) was to prevent members from using their personal, hobby or recreational expenses to offset income from unrelated business sources. S. Rep. No. 91-552, 91st Cong., 1st. Sess. 71 (1969). The statutory formula accomplishes this automatically in almost all cases, by strictly segregating exempt function and unrelated business income and expenses.

However, it is possible that, despite the statutory computational formula, some exempt function expenses could be placed in the unrelated business category. For example, a hunting club might hold an outing for nonmember friends of the members, and deliberately charge such nonmembers fees that were lower than variable (direct) costs. Too literal a reading of the statute could result in this type of activity being classified as unrelated business activity, and result in the deductibility of the directly connected net losses against other unrelated business net income. The application of the economic gain test shows that this type of activity is actually an exempt function activity.

At first blush the "economic gain" requirement appears to act in the same manner as the profit motive test proposed by the Government; however, that is not the case. The "economic gain" requirement is not a test of whether an expense directly connected to the production of unrelated business income is deductible, but is used to determine who actually pays for the cost of the activity, the members or the nonmembers. An activity results in

"economic gain" where the income from the activity exceeds the additional direct (variable) costs of conducting the activity, even though the income might not exceed the total of all variable and fixed costs combined. In that event, the members pay no additional amounts because of the activity. If the activity does not result in an "economic gain", however, the members pay some or all of the actual cost of the activity. If the members conduct or allow to be conducted activities which do not result in an "economic gain" for the benefit of nonmembers, there is a high degree of likelihood that the nonmembers are really guests of the members and that the activity is an exempt activity.[17]

Since the Cleveland Athletic Club always charged fees to nonmembers which exceeded variable costs, but had tax losses merely resulting from deductions of allocated fixed costs (e.g., depreciation, taxes, interest), the Sixth Circuit properly held that the "economic gain" test was satisfied. Similarly here, Petitioner always charged prices to nonmembers in excess of its variable costs; all of its deducted expenses satisfy the "economic gain" test.

E. Allowing Social Clubs to Aggregate Income and Losses on their Taxable Activities Provides Tax Parity Between Taxable Activities of Social Clubs and Taxable Businesses

Interpreting Section 512(a)(3)(A) so as to allow aggregation of tax profits and losses arising from a social club's

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[17] In other circumstances, income and expenses which are nominally from nonmember functions are treated as member income and expenses. For example, income from parties of eight or fewer persons is treated as member income, and directly connected deductions are member expenses, even if seven of the eight are nonmembers. Rev. Proc. 71-17, 1971-1 C.B. 683.

unrelated business activities best accommodates the terms and purposes of Section 512(a)(3)(A). One of the main purposes of Section 512(a)(3)(A) is to ensure that tax exempt social clubs have basically the same tax liabilities on their nonmember business income as taxpaying businesses. *See, e.g.*, S. Rep. No. 94-1318, 94th Cong., 2d Sess. 3 (1976-2 C.B. 597, 599). Thus a social club's service of meals to nonmembers should be taxed the same as a for-profit restaurant or hotel. For-profit businesses are allowed to deduct net losses from one business activity against net income from a different business activity.[18] A plain reading of Section 512(a)(3)(A) should allow an exempt social club to deduct net losses incurred in its food and beverage unrelated business from net income on its investment unrelated business.

This reading of Section 512(a)(3)(A) is supported by the history of the administration of the statute from 1969 to 1981, as embodied in the proposed Treasury Regulations and other administrative materials from that period. Proposed Regulations Section 1.512(a)-3 was issued by the I.R.S. fourteen months after enactment of Section

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[18] For example, the Service does not disallow deduction where a recreational facility operates at a loss on its food and beverage operations, but operates at a profit overall. If that were the case, every gambling casino, bowling alley, dinner theater, movie house, sports stadium, and other recreational facility would have to show continuing net tax profits on its food and beverage activity and each other activity in order to avoid disallowance of expenses. This Court can take judicial notice that recreational facilities typically show tax losses on one activity and tax profits on other activities, and are still allowed to deduct all expenses.

512(a)(3),[19] and remained outstanding until midway through the trial of this case in the Tax Court. These Regulations allowed a social club to aggregate all its unrelated gross income and deductions in one hotchpot, just as taxable businesses do, to determine the club's net unrelated business taxable income. Proposed Regulations § 1.512(a)-3(b)(3). As the Sixth Circuit and the Tax Court agreed[20]; these Regulations support the position that excess unrelated business food/beverage expenses should offset unrelated business investment income. From 1971 to 1987 these Proposed Regulations served as the rules for administration of Section 512(a)(3),[21] and I.R.S. administratively interpreted them to allow tax exempt social clubs to offset losses on food/beverage unrelated business activities against net income from investment unrelated business activities. It was only after the Sixth Circuit decided the issue in *Cleveland Athletic Club* adversely to I.R.S. that it withdrew these Regulations, without notice or comment, on January 26, 1987.

These Proposed Regulations, and their application during the immediate years after the enactment of

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[19] The Tax Reform Act of 1969 was enacted on December 30, 1969. Proposed Regulations § 1.512(a)-3 was issued on May 13, 1971, 36 Fed. Reg. 8809, and was withdrawn on January 26, 1987, 52 Fed. Reg. 2724.

[20] *Cleveland Athletic Club v. United States, supra*, at 1166; *North Ridge Country Club v. United States, supra*, 89 T.C. at 580.

[21] For example, I.R.S.' national training manual for 1980 states that "The proper method of allocating expenses for the purpose of determining tax in cases involving dual use of facilities or personnel is stated in Reg. 1.512(a)-1" – referring to Proposed Reg. § 1.512(a)-1. *Exempt Organizations Annual Technical Review Institutes for 1980*, Training 3177-01 (Rev. 2-80), p. 88.

Section 512(a)(3), constitute a contemporaneous construction of the statute. The Treasury's "substantially contemporaneous expressions of opinion are highly relevant and material evidence of the probable general understanding of the times and of the opinions of men who probably were active in the drafting of the statute. As such, they are entitled to serious consideration * * * ." *White v. Winchester Club*, 315 U.S. 32, 41 (1942); see *Better Business Bureau v. United States*, 326 U.S. 279, 286 (1945). Even contemporaneous private rulings have been accorded great weight.[22] This consistent contemporaneous administrative practice reflected in the Proposed Regulations should be accorded at least comparable weight.[23]

F. The Government's Profit-Equals-Taxable-Income Theory Emasculates the Exempt-Unrelated Business Dichotomy of Section 512(a)(3)

The Government's requirement—that in order to deduct expenses, a social club must have unrelated business gross income in excess of otherwise deductible unrelated business expenses—conflicts with the exempt function – unrelated business dichotomy in the statute, and goes far beyond any rule needed to preclude a club's deduction of personal, hobby or recreational expenses. The Government's proposed rule would treat as nondeductible exempt activity expenses a wide variety of expenses which have little or nothing to do with members' recreation or hobbies. For example, here most of the food-beverage

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[22] *Squire v. Capoeman*, 351 U.S. 1, 9 (1956); *Rowan Companies v. United States*, 452 U.S. 247, 261-262, fn. 17 (1981).

[23] Of course, we recognize that Proposed Regulations in and of themselves have no independent force or effect.

unrelated business activities were nonmember parties which by definition few members attended, and which were paid for by nonmembers. But the Government's formula would treat as nondeductible exempt activity expenses a portion of the expenses for light, heat, staff salaries, and other fixed expenses which are allocable to such nonmember parties. Such expenses are not hobby, recreational or other personal member expenses; they are the ordinary and necessary costs of generating the economic gains which were provided by the unrelated business activities. Indeed, the undisputed evidence here was that the unrelated business was a serious inconvenience to the members. (RT 28-34.)

The Government concedes that all interest and taxes allocated to the nonmember food and beverage functions are deductible because these statutes have no "trade or business" requirement. There is no rational basis in the Section 512(a)(3) terms, or in the intent to preclude hobby loss deductions, for distinguishing rent, heat, light and other fixed expenses and disallowing a deduction of a part thereof.[24]

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[24] The Proposed Regulations issued in 1971 allowed deduction of all – not some – allocated fixed expenses. Section 1.512(a)-3(b)(3) and (5) provide that all gross income and deductions not directly connected to exempt (member) gross income should be aggregated – including allocable portions of all fixed expenses – to arrive at taxable income. Section 1.512(a)-3(c)(iv) provides a sample computation in which the aggregated nonmember expenses are shown as one deduction number; there is no breakdown of nonmember profits or losses by fragmented activities.

Nothing in these Regulations suggests a disallowance of fixed expenses which are directly connected with nonexempt

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The Government is attempting to use this relatively small unrelated business tax case as a vehicle for establishing its novel theory that profit motive requires profit to equal taxable income. If this Court accepts that definition, I.R.S. will be able to deny loss deductions for other tax exempt organizations, and even taxable businesses, solely on the basis of computer runs of their past tax returns. Indeed, I.R.S. District Directors in Western states have done just that to many social clubs. The Government's rigid "taxable income" computational definition, and computer audits based thereon, fundamentally conflict with this Court's teachings that the "resolution of this issue 'requires an examination of the facts of each case.' " *Commissioner v. Groetzinger, supra,* at 988, quoting *Higgins v. Commissioner,* 312 U.S. 212, 217 (1941). What was said of a Government-proposed formula for determining nontaxable gifts applies a fortiori to the business expenses here (*Commissioner v. Duberstein,* 363 U.S. 278, 284, 289 (1960)):

> The Government suggests that we promulgate a new "test" in this area to serve as a standard to be applied by the lower courts and by the Tax Court in dealing with the numerous cases that arise. We reject this invitation. We are of the opinion that the governing principles are necessarily general and have already been spelled out in the opinions of this Court, and that the

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income, on the basis of profit motive or otherwise. Petitioner here exactly followed these Proposed Regulations. The Treasury Department has never issued any other Regulations which would require nondeductibility of fixed expenses directly connected with nonexempt income. The courts are not the place to legislate such a nondeductibility rule.

> problem is one which, under the present statutory framework, does not lend itself to any more definitive statement.

II

ALTERNATIVELY, IF THIS COURT INCORPORATES A PROFIT MOTIVE REQUIREMENT, IT SHOULD ADOPT THE TAX COURT'S ECONOMIC PROFIT TEST.

A. The Tax Court's Standard Properly Considers All Facts, Including Economic Profits

The Tax Court in its unanimous reviewed opinion in *North Ridge Country Club v. Commissioner,* 89 T.C. 563 (1987), as in the instant case, did not decide whether Section 162 was incorporated into Section 512(a)(3). Instead, it found that, even if it assumed Section 162 was so incorporated, then the two taxpayers earned a profit using the normal "economic profit" tests which courts have applied in business deduction cases under Sections 162, 165, and 167.

Under this standard profit motive standard, a taxpayer must have an actual and honest objective of making a profit. *Dreicer v. Commissioner,* 78 T.C. 642, 644-645 (1982); *Golanty v. Commissioner,* 72 T.C. 411, 425-426 (1979), *aff'd* without published opinion, 647 F.2d 170 (9th Cir. 1981). A taxpayer's expectation of making a profit need not be reasonable; it is sufficient that the taxpayer have a bona fide objective of making a profit. *Beck v. Commissioner,* 85 T.C. 557, 569 (1985); *Fox v. Commissioner,* 80 T.C. 972, 1006 (1983), *aff'd* without opinion, 742 F.2d 1441 (2d Cir. 1984); *Dreicer v. Commissioner,* 665 F.2d 1292, 1297 (D.C. Cir. 1981). In determining the intent of a taxpayer, all relevant facts and circumstances must be

taken into account. *Commissioner v. Groetzinger, supra; Bessenyey v. Commissioner*, 45 T.C. 261, 274 (1965).[25]

The Tax Court in the instant case and in *North Ridge* applied its usual facts and circumstances test for determining profit motives under the trade or business term in Sections 162, 165 and 167. It listed the following factors indicating profit motive, all of which are typical of those employed by courts over the years in making such determinations (as noted in the footnotes):

1. Petitioner's activities were run in a business-like manner. (J.A. 30.)[26]

2. It kept complete and accurate books and records of its activities. (J.A. 30.)[27]

3. Its operations were overseen by a board of directors of nine members which met at least monthly, and supervised and reviewed the actions of the general manager and other staff. (J.A. 30.)

4. Its board was made up of business people and professionals from various backgrounds, who met regularly, and discussed and dealt with the financial and other problems relating to nonmember food and beverage sales and financial operations. (J.A. 30)[28]

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[25] An exhaustive list of all possible factors under Section 162, and illustrative cases, is set forth in J. Lee, *A Blend of Old Wines in New Wineskins*, 29 Tax. L. Rev. 347, 395-464 (1974).

[26] *Bessenyey v. Commissioner*, 45 T.C. 261, 275 (1965), *aff'd*, 379 F.2d 252 (2d Cir. 1967), *cert. den.*, 389 U.S. 931 (1967); *Eastman v. United States*, 635 F.2d 833, 840 (Ct. Cl. 1980).

[27] E.g., *Whitney v. Commissioner*, 73 F.2d 589, 591 (3d Cir. 1934).

[28] E.g., *Roonen v. Commissioner*, 90 T.C. 74, 93-94 (1988).

5. It had a standing finance committee which met monthly to review financial statements, conduct studies concerning the financial aspect of petitioner's operations, and generally to discuss the implementing of board policy. (J.A. 30.)[29]

6. The finance committee regularly analyzed dining room finances, determined that private party (nonmember-unrelated) functions generated higher than average sales and resulted in a financial profit, and instituted programs to increase nonmember business. (J.A. 30-31.)[30]

7. Petitioner employed a full time, professional manager, who had a bachelor of science degree in hotel and restaurant administration and a bachelor of science degree in recreation administration; had previous employment experience with hotels and private clubs; and was a certified club manager who served as an officer of the local and state club and restaurant associations. (J.A. 30-31.)[31]

8. It encouraged nonmember food and beverage business with the intent to attract additional members to the club. The addition of new members resulted in increased income from each $7,000 initiation fee. Increased business also contributed to the sharpening of the skills of the chef and his staff. (J.A. 31.)[32]

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[29] E.g., *Babbitt v. Commissioner*, 23 T.C. 850, 867-868 (1955); *Churchman v. Commissioner*, 68 T.C. 696, 702 (1977).

[30] *Id.*

[31] E.g., *Appley v. Commissioner*, 39 T.C.M. 386 (1979); *Patterson v. United States*, 459 F.2d 487 (Ct. Cl. 1972); *Roonen v. Commissioner, supra*, at 95.

[32] See *Burleson v. Commissioner*, 46 T.C.M. 1394 (1983). The new members and additional business likely increased the value of Petitioner's facility, which indicates a profit motive. See pp. 40-41, *infra*.

The Government has not disputed that all of these factual findings are correct, or contended that they are not the usual and proper factors for determining whether a profit motive and a trade or business exist. However, the Government contends that the Tax Court legally erred in considering and giving weight to two other factors respecting profit motive – the Tax Court's findings (i) that Petitioner priced food and beverages served at nonmember activities at an amount intended to result in a profit to the club over the direct costs associated with the activity, and (ii) that Petitioner also earned a profit from nonmember sales when it deducted the variable costs, plus fixed expenses on a use of space allocation.

The Government contends that these findings are legally erroneous because they are assertedly premised on an erroneous definition of the term "profit" for purposes of determining profit motive. It insists that "profit" means an excess of gross income over deductible direct (variable) plus indirect (fixed) expenses, computed according to the allocation method used on the tax returns.

The Ninth Circuit rejected the tests of the Tax Court and the Government, and held that profit means an excess of gross income over variable plus fixed expenses, and expenses for this purpose may be computed using any reasonable allocation method (not necessarily that used for computing deductions on the tax return). (J.A. 44-45.)[33]

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[33] The Second Circuit in *The Brook, Inc. v. United States*, 799 F.2d 833 (2d Cir. 1986), held that Section 162 was incorporated into Section 512(a)(3)(A), but did not address the issue as to the definition of "profit" for profit motive purposes. This was because the taxpayer there broadly stipulated that it had no profit motive when it engaged in the unrelated activity of selling meals to nonmembers. *Id.*, 799 F.2d at 838.

We submit that, assuming Section 162 is incorporated into Section 512(a)(3)(A), the Tax Court's definition of profit motive is correct. That definition uses the same basic economic profit standards which it and other courts have applied in numerous cases which have determined profit motive for trade or business purposes in Sections 162, 165, and 167.

The cases have uniformly held that taxable businesses, in order to deduct expenses in excess of income, need only show an "economic profit" independent of tax savings[34], or "economic gain" independent of tax savings.[35] The Treasury Regulations which define profit motive for purposes of Section 512(a)(1) state that the term means "economic profit (without regard to tax consequences)."[36] While the "economic profits" and "economic gain" terms have been given slightly different meanings depending on the peculiar circumstances, the most common meaning is cash flow, or an excess of cash income over cash expenses.[37]

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[34] *Simon v. Commissioner*, 830 F.2d 499, 500 (3d Cir. 1987); *Surloff v. Commissioner*, 81 T.C. 210, 233-235 (1983) (economic profit is cash profit on each ton of coal in coal mining partnership); *Seaman v. Commissioner*, 84 T.C. 564, 588 (1985); *Rice's Toyota World, Inc. v. Commissioner* 81 T.C. 184, 202-210 (1983); *Ramsay v. Commissioner*, 83 T.C. 793, 810 (1984); see also *Landreth v. Commissioner*, 859 F.2d 643, 649 (9th Cir. 1988).

[35] *Hilton v. Commissioner*, 74 T.C. 305, 355-361 (1980) (economic gain in shopping center sale-leaseback can be pre-tax net income or loss plus net proceeds from mortgage financing, condemnation or sale, or cash flow; R. Waters, *Sideline Ventures; Planning to Achieve Maximum Tax Benefits from Losses Incurred*, 29 J. Tax 100 (1968).

[36] Treas. Regs. § 1.512(a)-1(f)(7)(ii).

[37] See, *e.g.*, S. Rep. No. 91-552, 91st Cong., 1st Sess. 212 (1969) (1969-3 C.B. 423, 557); H. Rep. No. 91-413, Pt. 1, 91st

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"Economic profit" is thus usually quite different from taxable income, for the latter includes all deductible expenses, not just out-of-pocket outlays.[38] In computing "economic profit," courts frequently allow the taxpayer to include not only current income, but also reasonably anticipated capital appreciation on the sale of the asset or business in question.[39] Section 183, which does not apply to corporations, but which incorporates tests for profit motive based on the cases, implicitly incorporates an "economic profit" test, for it recognizes that reasonably anticipated long-term increases in the value of the

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Cong., 1st Sess. 165 (1969) (1969-3 C.B. 303); H. Rep. No. 94-658, 94th Cong., 2d Sess. 31 (1976-3 C.B. (Vol. 2) 703, 723); *Waddell v. Commissioner*, 86 T.C. 848, 884 (Table 10), 887, 894 (1986); *Gefen v. Commissioner*, 87 T.C. 1471, 1490-1492 (1986) (profit equals cash flow plus residual value of property in sale-leaseback transaction); *Wildman v. Commissioner*, 78 T.C. 943, 954 (1982) (profit is cash return on cash investment, not taking into account potential payments due on nonrecourse note or non-cash deductions); J. Lee, *A Blend of Old Wines in a New Wineskin: Section 183 and Beyond*, 29 Tax Law Rev. 347, 380-385 (1974); R. Waters, *supra*, note 35.

[38] *Hartford v. United States*, 265 F.Supp 86, 88 (W.D. Wis. 1967) (profit means excess of gross income over cash expenses, not gross income over deducted expenses); cf. Treas. Regs. § 1.704-1(b)(3)(ii)(*b*) and 1.512(a)-1(f)(7)(ii); *Tolwinsky v. Commissioner*, 86 T.C. 1009, 1062 (1986).

[39] E.g., *George v. Commissioner*, 22 B.T.A. 189, 195 (1931) (cash profits plus appreciation in value of land held to constitute requisite profit); *Wroblewski v. Commissioner*, 32 T.C.M. 169, 172 (1973) (the same); *DuPont v. United States*, 234 F. Supp. 681, 688 (D. Del. 1964); J. Lee, *supra*, note 37.

property[40] constitute a factor in the profit motive determination.[41]

In *Estate of Baron v. Commissioner*, 83 T.C. 542, 556 (1984), the Government argued that "economic profit" was the correct standard for determining profit motive, while the taxpayer contended that tax savings should also be considered. The Court held that economic profit existed if there were cash profits, and they were not disproportionately lower than the tax savings.[42] In the instant case, Petitioner plainly satisfies this standard, because in the years in issue, it had cash profits of $50,741, but its tax savings were only $5,298.[43] (J.A. 29, 50.)

The tax shelter cases, where the issue of a Section 162 profit motive frequently arises, make no sense if one assumes that profit means taxable income. In most of the cases, it was conceded that the tax shelter would show continuous losses after deduction of noncash expenses; the issue was whether the shelter intended to earn an economic profit. If the Government's definition of profit is correct, most of the discussion of profit motive in these

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[40] Treas. Regs. § 1.183-2(b)(4); see Comment, *Analysis of New Code Section 183 and Some Ramifications for the Resort Home*, 9 Willamette L.J. 117, 122 (1973); J. Lee, *supra*, note 37, at 385-386.

[41] E.g., *Sanderson v. Commissioner*, 23 T.C.M. 1723, 1729 (1964).

[42] Accord, *Waddell v. Commissioner*, 86 *supra*, 894.

[43] A.C. Warren, *The Requirement of Economic Profit in Tax Motivated Transactions*, 59 Taxes 985, 991-992 (1981), disagrees that any comparison of tax benefits and cash flow should be made, and take the position that profit means a "barely positive return", *i.e.*, a small cash flow. Accord, I.H. Humphreys, *Establishing Profit Motive in Tax Shelters*, 3 J. Tax. of Investments 250, 259 (1986).

cases is useless verbiage. The cases should have been decided for the Government when the shelter entity disclosed its intent to generate continuing *tax* losses.

Thus, an office building partnership can deduct expenses in excess of income – created by permissible deductions for depreciation, interest, taxes, etc. – if it can demonstrate that it has a reasonable intent to earn economic profits, defined as gross income less the out-of-pocket expenses, but not taking into account the tax benefit of the write-offs – even if (as is usual) the entity shows continuing losses on its tax returns.

The I.R.S. itself, in its Tax Shelter Manual and in various rulings, has stated that profit motive requires an economic profit.[44] Indeed, in the only published ruling addressing the issue in the social club context, I.R.S. has stated that profit means gross income in excess of allocable *variable* costs. In Rev. Rul. 81-69, 1981-1 C.B. 351, it was held that a club did not have a profit motive when "it sold the food and beverages [to nonmembers] *at prices insufficient to recover the cost of sales* * * *[45] Despite the clear wording of this Ruling, however, I.R.S. has administratively determined that Petitioner and other clubs did not have a profit motive even where gross income *exceeded costs of sales*, but was less than the sum of deductible fixed costs plus deductible costs of sales.

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[44] I.R.S. Examination Tax Shelters Manual, par. 444(3)(c) (May, 1989); *cf.* Rev. Proc. 75-21, 1975-1 C.B. 715, 716.

[45] Webster's *Third New International Dictionary* (unabridged) defines "cost of sales" to mean "1. * * * the purchase cost or inventory value of merchandise sold during a stated period plus the cost of direct work thereon * * * ; 2. * * * the production costs or inventory value of goods sold during a stated period. * * * ."

B. The Government's Taxable Income Test is Inconsistent with the Profit Motive Test Applied to Taxable Corporations

The Government's position in this case, that a profit motive cannot exist where a taxpayer has consistent *tax* losses, is simplistic and ignores the realities of federal income taxes in modern times. If that position were correct, Congress' enactment, and repeated refining and tightening of the minimum tax and the alternative minimum tax, would not have been necessary. These taxes are required because of "existing tax preferences . . . which generally cause a taxpayer's taxable income to be less than economic income . . . ." U.S. Treasury Dept., *Tax Reform for Fairness, Simplicity, and Economic Growth*, Vol. 2, at 114 (Nov. 1984). Indeed, in the Tax Reform Act of 1986, Congress recognized that corporations can generate significant economic profits but nonetheless report continuing tax losses, and specifically provided that corporations must use book income, rather than taxable income, for purposes of computing the alternative minimum tax. *See*, Section 56(f) of the Internal Revenue Code of 1986.[46] Obviously, these minimum tax provisions would not be necessary if the Government could merely hold that a corporate taxpayer had no profit motive on any activity where tax deductions consistently exceeded gross income (*e.g.*, oil and gas drilling and exploration activities), and disallowed deductions for expenses in excess of gross income. The Government has never, however, claimed

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[46] The Tax Reform Act of 1986 has a whole set of provisions designed to deal with problems which are titled "Business untaxed reported profits." In pre-1986 years, the reported profits were "untaxed" because the corporations had *deductible* costs in excess of gross income.

such authority with regard to taxable corporations, and has instead attempted to limit the tax advantages of tax deductions in excess of gross income through the minimum tax and the alternative minimum tax.[47]

Code Section 56(f) adds to the tax preference items of a corporation a percentage of the untaxed reported profits of that corporation. If "profits" were "taxable income" as maintained by the Government, this statute would never add a penny to a corporation's preference items for minimum tax purposes, because they would always be taxed as "taxable income" under Code Section 11. If the I.R.S had confidence in the argument made in this case, that a series of years in which a corporation had no taxable income and paid no taxes proves it had no profit motive, Code Section 56(f) would have been unnecessary.

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[47] A former Treasury Department tax advisor described the problem as follows (M. Hevener, *Minimum Tax and Alternative Minimum Tax, Computation and Application*, 288-3d Tax Management A-70 (1987)):

> Theoretically, there should be little disparity between income for financial accounting purposes and income for tax purposes as long as the income tax base is reasonably comprehensive and deductions are limited to those required to accurately measure net income. In recent years, however, the regular federal income tax system has fallen far short of satisfying these two conditions, and the supplementary minimum tax system has not come that much closer. The Tax Reform Act of 1986 represents probably Congress' most determined effort ever to bring the federal income tax base closer to economic income. In particular, the revised minimum tax rules, eliminating for minimum tax purposes the incentive effect of the bulk of preferences still allowed for regular tax purposes.

Congress determined Code Section 56(f) necessary because many very profitable corporations were consistently deducting expenses in excess of gross income, and thus never paying income taxes.[48]

If this Court were to accept the Government's definition of profit, it would reasonably conclude that none of the corporations listed in the margin was engaged in activities with an intent to make a profit. These corporations, just as Petitioner, used the available choices in the Code to reduce their taxes to zero. These corporations, just as Petitioner, intended to make an economic profit. These corporations, as well as the Petitioner, actually did make an economic profit. They merely chose to use the flexibility built into the code to reduce their taxes legally, by not reporting a tax profit.

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[48] From 1981 through 1984, the following corporations paid no federal income tax, but reported profits each year to the SEC and their shareholders as noted below (Citizens for Tax Justice, *130 Reasons Why We Need Tax Reform* (July 1986)):

Corporations	1981-84 Reported Profits
Boeing Company	$2,099,000,000
Lockheed Corporation	$1,670,900,000
Grumman Corporation	$ 653,400,000
Greyhound Corporation	$ 419,900,000

From 1982 through 1985, the following corporations paid no federal tax, but reported profits each year to the SEC and their shareholders as listed below (*id*):

Corporations	1982-85 Reported Profits
Middle South Utilities	$2,477,800,000
General Dynamics	$1,994,500,000
Panhandle Eastern Corporation	$1,063,500,000
Union Can Corporation	$ 690,900,000
Transamerica Corporation	$ 525,000,000
Mitchell Energy and Development	$ 362,900,000
Coamerica	$ 169,300,000

If "profit" and "taxable income" were the same, the question whether a taxpayer has a profit motive could depend on whether it elected an accrual or a cash method of accounting, whether it elected to amortize or capitalize certain expenses, whether it elected accelerated or straight line depreciation, or even in which year it would choose to purchase a capital asset. These decisions do not increase or decrease the gross economic income of the taxpayer, nor do they increase or decrease the actual expenses paid; they merely regulate the tax treatment of the income and expenses.

C. The Government's Taxable Income Test Is Inconsistent with Basic Accounting Definitions of Profit

The concept of earning economic gain or profit, in the sense of revenues exceeding direct (variable) expenses, is well accepted in the accounting field. It is based on the common sense notion that if certain overhead costs are relatively fixed, any extra business which generates revenues in excess of variable costs increases the amount of funds available to the business. This is why restaurants can afford to offer discount meals at off-peak times, and still make a profit on them.

In accounting, economic profit is determined under a "relevant cost approach"[49], which is shown on a "contribution form of economic statement."[50] This is quite different from the "function form of income statement," which spreads all fixed and variable costs equally over all sales,

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[49] C.T. Horngren, *Introduction to Management Accounting*, (4th ed. 1978), 81.

[50] Horngren, *supra*, at 65-66, 86-87.

and results in a type of profit similar to that contended by the Government.[51]

Using the contribution form of economic statement in Professor Horngren's text, Petitioner had roughly $22,601 and $28,140 greater net income with its nonmember business than without it in 1980 and 1981 respectively.[52] By generating a total of $190,000 in unrelated business sales in 1980-1981, Petitioner produced a total of $50,000 in funds which it otherwise would not have had.[53] Dropping nonmember business would cause a decrease in the Petitioner's overall economic net income of about $50,000 for the two years in issue.[54] Such extra income produced by nonmember business is surely "profit" under any realistic definition of a "profit motive."

D. The Ninth Circuit's Profit Motive Formula Is Totally Unprecedented and Untested

The Ninth Circuit's opinion cites no authority for its position that profit means an excess of gross income over the sum of variable costs, plus fixed costs computed under any proper allocation method. That definition is contrary to the "economic profit" standard which has been consistently applied by the decisions, and approved by the commentators discussed in Part II, A, above. The

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[51] *Id.* at 87.

[52] See Tables 1 and 2, Appendix C, *infra*, which follow the format in the Horngren accounting text, *supra*, at 87, Ex. 4-3. These tables were included in Petitioner's Tax Court brief.

[53] *Id.*, Tables 1, 2.

[54] *Id.*

Ninth Circuit's text is also in conflict with the accounting notion of economic profit. (See Part II, C, above.) These authorities hold that economic profit is gross income in excess of variable expenses.

While the Ninth Circuit's formula is better than that of the Government, it is basically unprincipled and conflicts with the reality of economic profits. If this Court were to adopt this test, we believe that the Tax Court's opinion should be affirmed. No remand would be necessary, since the Tax Court already found that Petitioner had a profit, and a profit motive, when profit means gross income in excess of variable and fixed costs, using the actual use method of allocating for fixed costs. (J.A. 28-29.)

CONCLUSION

For the reasons stated, the judgment of the Ninth Circuit should be reversed.

Respectfully submitted,

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APPENDIX A

INTERNAL REVENUE CODE OF 1954 (26 U.S.C.):

Sec. 511. IMPOSITION OF TAX ON UNRELATED BUSINESS INCOME OF CHARITABLE, ETC., ORGANIZATIONS.

(a) Charitable, Etc., Organizations Taxable at Corporation Rates. –
  (1) Imposition of tax. – There is hereby imposed for each taxable year on the unrelated business taxable income (as defined in section 512) of every organization described in paragraph (2) a tax computed as provided in section 11. In making such computation for purposes of this section, the term "taxable income" as used in section 11 shall be read as "unrelated business taxable income."
  (2) Organizations subject to tax. –
    (A) Organizations described in sections 401(a) and 501(c). – The tax imposed by paragraph (1) shall apply in the case of any organization (other than a trust described in subsection (b) or an organization described in section 501(c)(1) which is exempt, except as provided in this part or part II (relating to private foundations), from taxation under this subtitle by reason of section 501(a).

Sec. 512. UNRELATED BUSINESS TAXABLE INCOME

(a) Definition. – For purposes of this title –
  (1) General rule. – Except as otherwise provided in this subsection, the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated

trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

* * *

(3) Special rules applicable to organizations described in section 501(c)(7) or (9). –

(A) General rule. – In the case of an organization described in section 501(c)(7) or (9), the term "unrelated business taxable income" means the gross income (excluding any exempt function income), less the deductions allowed by this chapter which are directly connected with the production of gross income (including exempt function income), both computed with the modifications provided in paragraphs (6), (10), (11), and (12) of subsection (b). For purposes of the preceding sentence, the deductions provided by sections 243, 244, and 245 (relating to dividends received by corporations) shall be treated as not directly connected with the production of gross income.

(B) Exempt function income. – For purposes of subparagraph (A), the term "exempt function income" means the gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members or their dependents or guests goods, facilities, or services in furtherance of the purposes constituting the basis for the exemption of the organization to which such income is paid. Such term also means all income (other than an amount equal to the gross income derived from

any unrelated trade or business regularly carried on by such organization computed as if the organization were subject to paragraph (1)), which is set aside –

(i) for a purpose specified in section 170(c)(4), or

(ii) in the case of an organization described in section 501(c)(9), to provide the payment of life, sick, accident, or other benefits, including reasonable costs of administration directly connected with a purpose described in clause (i) or (ii). If during the taxable year, an amount which is attributable to income so set aside is used for a purpose other than that described in clause (i) or (ii), such amount shall be included, under subparagraph (A), in unrelated business taxable income for the taxable year.

APPENDIX B

NET INCOME OF PORTLAND GOLF CLUB COMPUTED PER "SQUARE FOOT AND HOURS OF ACTUAL USE" ALLOCATION METHOD

	11 Months Ending 9/30/80			Year ending 9/30/81		
	Dining Room	Bar	Total	Dining Room	Bar	Total
Sales	$68,122	$16,300	$84,422	$85,134	$21,413	$106,547
Variable expenses:						
Food & Liquor	27,249	5,183	32,432	34,054	6,617	40,671
Labor & Other Related Costs	14,540	5,281	19,821	16,868	7,259	24,127
Other	8,362	1,206	9,568	11,853	1,756	13,609
	$50,151	$11,670	$61,821	$62,775	$15,632	$78,407
Excess of Sales over Variable Expenses	$17,971	$ 4,630	$22,601	$22,359	$ 5,781	$28,140
Fixed Expenses	3,153	0 *	3,153	4,666	0 *	4,666
Profit	$14,818	$ 4,630	$19,448	$17,693	$ 5,781	$23,474

*Fixed expenses are included under Dining Room.

Source: J.A. 29.

APPENDIX C

TABLE 1
Comparison of Operating Income of Taxpayer
With and Without Noninvestment Unrelated Business
Income Eleven Months ending September 30, 1980*

Revenues	Without Unrelated Business	With Unrelated Business			Difference With Nonmember Unrelated Business
		Related	Unrelated	Total	
Dues and Initiation Fees	$ 781,422	$ 781,422	$ –	$ 781,422	
Total Related Sales from Food, Beverage & Other Service Programs	765,448	765,448	84,422	849,870	$84,422
Total Revenues	$1,546,870	$1,546,870	$84,422	$1,631,292	$84,422
Less Related Variable Expenditures	1,273,749	1,273,749	61,821	1,335,570	61,821
Contribution Margin	$ 273,121	$ 273,121	$22,601	$ 295,722	$22,601
Less Total Fixed Expenses	156,749	–	–	156,749	0
Operating Income	$ 116,372	–	–	$ 138,973	$22,601

* Figures were obtained from Form 990, the audited financial statement of Petitioner for years ending September 30, 1980 and September 30, 1981, adjusted to reflect 11 months taxable year for 1980 (J.A. 52-72) and from Exhibits 15-O (J.A. 85), 16-P and 17-Q.

TABLE 2
Comparison of Operating Income of Taxpayer With and Without Noninvestment Unrelated Business Income Fiscal Year ending September 30, 1981*

Revenues	Without Unrelated Business	With Unrelated Business			Difference With Nonmember Unrelated Business
		Related	Unrelated	Total	
Dues and Initiation Fees	$ 840,929	$ 840,929	$ –	$ 840,929	
Total Related Sales from Food, Beverage & Other Service Programs	871,619	871,619	106,547	978,166	$106,547
Total Revenues	$1,712,548	$1,712,548	$106,547	$1,819,095	$106,547
Less Related Variable Expenditures	1,512,185	1,512,185	78,407	1,590,592	78,407
Contribution Margin	$ 200,363	$ 200,363	$ 28,140	$ 228,503	$28,140
Less Total Fixed Expenses	159,491	–	–	159,491	0
Operating Income	$ 40,872	–	–	$ 69,012	$28,140

* Figures were obtained from Form 990, the audited financial statement of Petitioner for years ending September 30, 1980 and September 30, 1981, adjusted to reflect 11 months taxable year for 1980 (J.A. 52-72) and from Exhibits 15-O (J.A. 85), 16-P and 17-Q.

(5)

No. 89-530

FILED
APR 2 1990
JOSEPH F. SPANIOL, JR.
CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1989

PORTLAND GOLF CLUB, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT

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QUESTION PRESENTED

Petitioner, a tax-exempt social club, earns gross income from the sale of food and drink to nonmembers. The variable costs of conducting this activity are less than the gross receipts, but petitioner reports a net loss from the nonmember sales because the total expenses allocated to it (both fixed and variable) always exceed the gross receipts. The question presented is whether, in determining petitioner's "unrelated business taxable income" (26 U.S.C. 511-512), these reported net losses from nonmember sales can be used to offset petitioner's unrelated investment income.

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BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-3a) is unreported. The memorandum opinion of the Tax Court (Pet. App. 6a-42a) is unofficially reported at 55 T.C.M. (CCH) 212.

JURISDICTION

The judgment of the court of appeals (Pet. App. 4a-5a) was entered on June 1, 1989. On August 28, 1989, Justice O'Connor extended the time within which to file a petition for a writ of certiorari to and

including September 29, 1989. The petition was filed on September 28, 1989, and was granted on January 16, 1990. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTORY PROVISIONS INVOLVED

Sections 511 and 512 of the Internal Revenue Code (26 U.S.C.) are set forth in pertinent part in a statutory appendix (App., *infra*, 1a-3a).

STATEMENT

1. Petitioner is a corporation exempt from income tax as a "social club" under Section 501(c)(7) of the Internal Revenue Code,[1] which grants tax-exempt status to "[c]lubs organized for pleasure, recreation, and other nonprofitable purposes" that meet certain other requirements. Petitioner operates a private country club that has a golf course, restaurant and bar, swimming pool, and tennis courts, primarily for use by members and their guests. Nonmembers are permitted to use petitioner's restaurant and bar for banquets, receptions, and similar functions, if they are sponsored by members. Petitioner receives gross income that is unrelated to its exempt purposes—and hence subject to unrelated business income tax under Sections 511-512 of the Code—from two sources: sales of food and drink to nonmembers and interest upon its investments. Pet. App. 8a-11a.[2]

[1] Unless otherwise noted, statutory references are to the Internal Revenue Code of 1954 (26 U.S.C. (1976)), as in effect during 1980 and 1981, the tax years involved (the Code or I.R.C.).

[2] The Code imposes a tax, at regular corporate rates, on an exempt organization's "unrelated business taxable income." I.R.C. § 511. The "unrelated business taxable income" of a social club is defined by Section 512(a)(3)(A) as "the gross income (excluding any exempt function income), less the deductions allowed by this chapter [Chapter 1 of the Code] which are directly connected with the production of the gross income (excluding exempt function income)." Because the "exempt function income" is confined to membership dues and other receipts from members (see I.R.C. § 512(a)(3)(B)), all of the income that a social club receives from nonmembers, as well as interest and dividends that accrue upon its investments, is subject to unrelated business tax, whether or not the income derives from a trade or business. This treatment differs from that accorded by the Code to most other tax-exempt organizations, including charitable organizations granted exemption by Section 501(c)(3). Their "unrelated business taxable income" is defined by Section 512(a)(1) as limited to gross income from an "unrelated trade or business," reduced by "the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business." Thus, in contrast to the Code's treatment of social clubs, investment income earned by these other kinds of tax-exempt organizations is not taxable.

On its tax returns for 1980 and 1981, petitioner computed its gain or loss from the nonmember sales by deducting from gross income both "direct" or "variable" expenses (*i.e.*, those that vary with the volume of sales, such as food and beverage costs, payroll, and supplies) and also an allocable share of "indirect" or "fixed" expenses (such as taxes, depreciation, insurance, and other fixed overhead), which petitioner would have incurred to operate its facilities whether or not it served nonmembers. The allocable share of fixed expenses was deducted on the basis of petitioner's claim that those expenses were "directly connected with the production of" nonexempt income (I.R.C. § 512(a)(3)(A)); the allocation was made based on the ratio of petitioner's gross receipts from nonmember sales to its total gross receipts from sales

of food and drink to both members and nonmembers. Pet. App. 11a-13a.[3]

Petitioner's gross receipts from the nonmember sales for each year exceeded the variable expenses of that activity, but were less than the sum of the variable and allocated fixed expenses. Accordingly, petitioner reported that the nonmember food enterprise generated net losses for each year—$28,433 for 1980 and $69,608 for 1981.[4] Those losses were greater than petitioner's interest income of $11,752 for 1980 and $21,414 for 1981. Petitioner offset the losses

[3] Under Treas. Reg. § 1.512(a)-1(c), where expenses are incurred or facilities are used for both exempt and nonexempt purposes, depreciation, overhead, and similar expenses should be allocated on a reasonable basis. Expenses that are so allocated to the nonexempt activity are treated as "directly connected" to the nonexempt activity. The Commissioner did not challenge the allocation made by petitioner in this case; the parties stipulated that the allocation was reasonable. Pet. App. 12a-13a & n.5; J.A. 17.

[4] Petitioner's income tax returns did not reflect that the gross income from the nonmember sales exceeded the variable expenses. See J.A. 53, 65. In fact, the return for 1981 reported that the "cost of goods sold * * * and operations" for the nonmember sales exceeded the gross receipts. J.A. 65. But a schedule prepared by petitioner for this litigation reflected that gross receipts from nonmember sales exceeded variable costs (J.A. 85), and the Tax Court found this to be the case (Pet. App. 14a-16a, 37a n.11). According to that schedule, the net losses from nonmember sales claimed by petitioner may be reconstructed as follows:

	1980	1981
Gross income	$84,422	$106,547
Variable expenses	(61,821)	(78,407)
Allocated fixed expenses	(51,034)	(97,748)
Net loss	($28,433)	($69,608)

against the interest income, and therefore it reported no unrelated business income tax liability for 1980 or 1981. Pet. App. 21a-22a.[5]

On audit, the Commissioner determined that the losses reported by petitioner from its nonmember sales were not deductible—*i.e.*, that while the expenses allocated by petitioner to nonmember sales could be applied to reduce its income from those activities, the excess expenses could not be used to offset its unrelated investment income and shelter it from taxation. Accordingly, the Commissioner asserted tax deficiencies of $1,828 for 1980 and $3,470 for 1981 to reflect the tax due on petitioner's investment income. Pet. App. 7a; J.A. 48-51. The Commissioner reasoned that the excess expenses of a social club's nonmember activities are deductible only if petitioner carries on the nonmember sales activity with a profit motive.[6] The Commissioner found that

[5] Petitioner likewise reported net losses from nonmember sales on its tax returns for every year during the 1975-1984 period (Pet. App. 13a). As of the close of 1984, petitioner's cumulative net operating loss from nonmember sales was $418,449. J.A. 91.

[6] The general rule under the income tax law is that the expenses of a not-for-profit activity may be offset against the income from that activity, but excess expenses may not be applied against income from other sources. See 1 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 22.5.4, at 22-63 to 22-64 (1989); *Five Lakes Outing Club* v. *United States*, 468 F.2d 443, 446 (8th Cir. 1972) (expenses of not-for-profit activity are allowable up to, but only up to, gross income from the activity; this is "the procedure the Commissioner has long used with court approval"); cf. I.R.C. § 183. This rule reflects the Code's general determination to tax, not gross income, but net income, *i.e.*, gross income reduced by the expenses necessary to produce that income. The deduction of excess expenses (*i.e.*, those that pro-

petitioner lacked the requisite profit motive for the nonmember activity because the food and drink were priced at a level insufficient to recover the total costs allocated to that activity, so that the nonmember sales consistently yielded net losses. Pet. App. 22a-23a; J.A. 51.

2. Petitioner challenged the Commissioner's determination in the Tax Court, which ruled in its favor (Pet. App. 6a-42a). The court held that the expenses allocated to petitioner's nonmember activities could be deducted in full and therefore used to reduce its unrelated investment income. The court assumed (without deciding) that petitioner could deduct against other income its expenses from nonmember sales only if that activity was profit-motivated, but the court concluded that that standard was satisfied because petitioner intended that its gross receipts from the nonmember sales would exceed the related "direct costs" (*id.* at 35a), *i.e.*, "the cost related to those sales which would not have been incurred absent those sales" (*id.* at 37a). See *id.* at 34a-42a.

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duce losses) against income from a different source, however, does not implicate this principle; there is nothing inherently unreasonable about taxing what are genuine earnings from one source even if the taxpayer has incurred losses elsewhere. Accordingly, such excess expenses may be deducted only if specifically authorized by the Code. While the deduction of excess expenses ordinarily is authorized by the Code only when incurred in profit-motivated activity, Sections 163 and 164 of the Code are exceptions to that rule; interest and taxes may be deducted whether or not the taxpayer engaged in the activity with a profit motive. In this case, the sum of the interest and taxes claimed by petitioner as deductions connected with its nonmember sales was only $2,862 for 1980 and $3,686 for 1981 (J.A. 53, 65), and therefore those items were encompassed in the amounts that the Commissioner allowed petitioner to offset against its gross receipts from nonmember sales.

The court stated that the net losses consistently reported on petitioner's tax returns were not evidence that the sales lacked a profit motive, because those losses resulted "only by allocating a part of the expenses which petitioner would have in all events incurred" (*id.* at 37a-38a). Thus, although petitioner had allocated a portion of its fixed overhead expenses to its nonmember activity in order to generate tax losses from that activity (on the assertion that those fixed expenses were "directly connected" to the activity), the court permitted petitioner to disregard those overhead expenses in determining whether it had the requisite profit motive with respect to the nonmember activity to allow it to be able to use those losses to reduce its investment income (see *id.* at 38a-39a). The Tax Court relied heavily on its reviewed decision in *North Ridge Country Club* v. *Commissioner*, 89 T.C. 563 (1987), rev'd, 877 F.2d 750 (9th Cir. 1989), where it had ruled that it would not evaluate a club's profit motive from the standpoint of "taxable profit," but would look instead to the "incremental increase in available funds" realized by the club from the activity (89 T.C. at 572).

3. The court of appeals reversed and remanded (Pet. App. 1a-3a), on the authority of its opinion reversing the Tax Court in *North Ridge*, where the court of appeals had held that losses from nonmember activity cannot be used to offset a social club's investment income, unless the nonmember activity is conducted with a profit motive—taking into account fixed, as well as variable, expenses. In *North Ridge*, the court of appeals had expressly rejected the position taken by the Sixth Circuit in *Cleveland Athletic Club* v. *United States*, 779 F.2d 1160, 1165 (1985), to the effect that net losses from nonmember activity may be applied to reduce investment income so long

as the nonmember activity is carried on for "economic gain," *i.e.*, with the intent of collecting gross receipts in excess of variable costs. Instead, the Ninth Circuit agreed with *The Brook, Inc.* v. *Commissioner*, 799 F.2d 833, 839 (2d Cir. 1986), that "a social club must pursue a nonmember activity with a profit motive before it can properly deduct its losses under section 512(a)" (877 F.2d at 754). The court grounded that conclusion both upon the language of the statute, which limits a social club's deductions to those "allowed by this chapter," and upon the statute's legislative history, which indicates that a social club's nonexempt income should be taxed according to the same principles that apply generally to other taxpayers under the Code. In particular, the court found that Section 512(a)(3) incorporates the principles applicable to Section 162, so that expenses of the kind claimed by petitioner are deductible (in excess of gross receipts) only if the operation is conducted with a profit motive (*ibid.*).

The Ninth Circuit in *North Ridge* proceeded to hold that the profit motive test imposed as a condition to deducting excess expenses of a nonmember activity under Section 512(a)(3) is not satisfied unless a social club conducts that activity for "the production of gains in excess of all direct and indirect costs" (877 F.2d at 756). The court specifically rejected the Tax Court's view that a club's "intent to derive economic benefit from nonmember activity, before considering indirect costs," can satisfy the profit motivation requirement of the statute (*ibid.*). The court concluded that the Tax Court's interpretation of the statute would erroneously allow a portion of the club's nonexempt income to go untaxed, thus "manifestly" producing "the sort of tax-free subsidy to social club members that section 512(a) sought to prevent" (*ibid.*).

In this case, the court of appeals stated that the Tax Court had "appl[ied] the same standards we rejected in *North Ridge*," and accordingly it reversed (Pet. App. 2a). The court remanded to the Tax Court "for a determination of whether [petitioner] engaged in its non-member activities with the intent required under *North Ridge* to deduct its losses from those activities" (*id.* at 3a).[7]

SUMMARY OF ARGUMENT

A. 1. Since 1950, tax-exempt organizations have been subject to tax on certain income unrelated to their exempt purposes. The general operation of the relevant Code provisions is to classify some of the organization's income as "unrelated business taxable income," and then to tax that income in conformity with the same principles applicable to other taxpayers. In 1969, Congress enacted Section 512(a)(3) of the Code, which differentiates the tax treatment of social clubs from that of most other tax-exempt organizations. Congress determined that it was inconsistent with the rationale for the tax exemption of social clubs to allow them to use tax-exempt outside income to subsidize the recreational activities of their members. Accordingly, it provided that all income received by a social club from a nonmember source,

[7] Petitioner had argued in the Tax Court that it could have shown a net profit on its nonmember sales if it had chosen a different method of allocating the fixed costs to that activity—specifically, if it had allocated the costs according to actual use of facilities instead of gross receipts. See Pet. App. 14a-16a; J.A. 22. The purpose of the remand appears to be to allow the Tax Court to consider the argument that petitioner should be allowed to demonstrate a profit motive by using an actual use (or other) method of allocation, while continuing to use the gross receipts method of allocation in computing its taxes in order to generate tax losses that can be used to reduce its taxable income from investments.

including passive investment income, would be subject to the tax on unrelated business income. This provision deliberately expands the income tax base for social clubs as compared to most other tax-exempt organizations, which are taxed only on income produced by an unrelated "trade or business" (I.R.C. § 512(a)(1)).

The principle that tax-exempt organizations are to be taxed on their nonexempt income in essentially the same manner as other taxpayers was made fully applicable to social clubs. Thus, Section 512(a)(3) does not independently render any particular expenses deductible from a social club's taxable gross income; rather, like the parallel provision applicable to other tax-exempt organizations, it addresses the question of allowable deductions by cross-reference. A social club's nonexempt gross income may be reduced by "the deductions allowed by this chapter [Chapter 1 of the Code] which are directly connected with the production of the gross income."

2. Petitioner must demonstrate that its nonmember activity was conducted with a profit motive in order to deduct its excess expenses against unrelated investment income. For purposes of deducting expenses, the Code generally draws a distinction between activities that are undertaken for profit and those that are not. Although the gross income from any activity may be reduced by the expenses incurred to produce that income, excess expenses of an activity (which produce tax "losses") may be deducted from income derived from other sources only if the activity is intended to produce a profit. Because Section 512(a)(3) limits a social club's deductions to those "allowed by this chapter," this distinction is controlling here.

As petitioner acknowledges (Br. 10), the expenses that it seeks to deduct here are almost entirely "business expenses," such as payroll, insurance, and cost of goods sold. These expenses are rendered deductible under the Code, if at all, only by Section 162 and related provisions, which allow such deductions if incurred in a "trade or business." And it is well settled that the existence of a profit motive is essential to finding that an activity constitutes a "trade or business." Thus, in the absence of a profit motive, deductions of the kind of expenses at issue here are not "allowed by [Chapter 1]" of the Code and therefore are not allowable to petitioner.

B. The court of appeals correctly rejected petitioner's contention that its nonmember activity was profit-motivated because it was designed to produce gross receipts in excess of *variable* costs, albeit not in excess of the sum of variable costs and the fixed costs allocated as "directly connected" (§ 512(a)(3)) with that activity. The established approach for determining the existence of a profit motive is to examine the taxpayer's intent to generate gross receipts that will exceed *all* properly allocated expenses—both fixed and variable. Distinguishing between these two kinds of expenses is potentially significant in a "dual use" situation such as this one or, more typically, where a taxpayer uses property primarily for personal reasons but also to produce income. The courts have consistently held in the latter situation that it is not sufficient to establish profit motive for the taxpayer to show merely that he engages in an income-producing activity to defray the expenses of maintaining the property—such as renting a vacation home that is primarily held for personal use. The mere fact that the rental or other activity may bring in funds in excess of variable costs does not establish a profit motive that would allow the taxpayer to deduct excess expenses (whether variable or fixed) against unrelated income.

Petitioner's position also should be rejected because it rests on an inherent contradiction. The fundamental premise of petitioner's claim is that the expenses it seeks to deduct—including an allocated portion of the fixed expenses—were "directly connected" with the production of nonmember income. Petitioner should not then be permitted to reverse its field and maintain that these "directly connected" expenses are to be disregarded in the profit motive calculation. Either the allocable portion of the fixed expenses are "ordinary and necessary costs of generating" the nonmember income (Pet. Br. 33) or they are not. Moreover, the consequence of petitioner's interpretation would be to allow most social clubs, by engaging in the common practice of providing some goods and services to nonmembers, to utilize their normal overhead expenses to eliminate the tax on their investment income—thereby subverting the specific purpose for which Section 512(a)(3) was enacted.

ARGUMENT

PETITIONER'S REPORTED NET LOSSES FROM SALES OF FOOD AND DRINK TO NONMEMBERS MAY NOT BE USED TO REDUCE ITS UNRELATED INVESTMENT INCOME

In Sections 511-513 of the Code, Congress has established a comprehensive scheme governing the taxation of some of the income received by organizations that are generally tax-exempt under Section 501(c). For most of these organizations, Congress has determined that income generated by an unrelated trade or business should be taxable, but passive investment income should be tax-exempt. For social clubs like petitioner, however, Congress has determined that investment income should also be taxable, and it enacted a separate provision of the Code, Section 512(a)(3), to accomplish that goal. Petitioner here

argues for a statutory interpretation that would substantially defeat that congressional determination—by allowing social clubs pursuing their usual activities to escape taxation on their investment income.

It is a common practice for social clubs periodically to make their facilities and food services available to nonmembers for a fee, in order to raise money to defray the expenses of operating the club. Petitioner maintains that, through an allocation of its fixed operating expenses to such nonmember sales, it can treat this activity as generating tax losses that completely eliminate taxation of its investment income. If correct, this approach would allow social clubs routinely to use untaxed income from their investments to subsidize their members' recreational activities—in clear derogation of Congress's specific decision to the contrary.

But petitioner's analysis is fallacious. It is able to read Section 512 to accomplish this result only by disregarding settled rules regarding the deductibility of expenses or by manipulating the allocation of expenses to the nonmember sales in a manner that violates both traditional tax analysis and basic principles of consistency. Specifically, petitioner argues that social clubs have been granted a unique exemption from the generally applicable limitation that certain kinds of expenses are deductible only if incurred in connection with profit-motivated activity. And, alternatively, petitioner contends that it can demonstrate the existence of a profit motive by disregarding the fixed expenses allocated to its nonmember activity, while at the same time employing an allocable share of those fixed expenses to generate the tax losses that it seeks to use to shelter its investment income. Both contentions violate basic tax principles embodied in Section 512(a)(3) and would eviscerate the congressional policy underlying that provision.

A. A Social Club May Not Offset Against Its Investment Income Net Losses From Nonmember Sales Activity That Is Not Conducted With A Profit Motive

Petitioner acknowledges (Br. 10) that the expenses of its nonmember sales activity that it seeks to deduct from its investment income—such as cost of goods sold, payroll, depreciation, insurance, and similar items (see Pet. App. 11a)—are "the types of corporate expenses" whose deductibility ordinarily must be grounded in Section 162 and related provisions of the Code allowing certain deductions for "business expenses." See also Br. 21-22. Petitioner also recognizes that, under the Code in general, "a profit motive is a necessary factor in determining whether an activity is a trade or business" (Br. 23; see also *id.* at 10, 22). But petitioner disputes the logical consequence of these principles—namely, that a social club cannot deduct from investment income such "business expenses" of its nonmember activity unless that activity is profit-motivated. Instead, petitioner argues (Br. 16-35) that Section 512(a)(3) confers a unique tax benefit upon social clubs by enabling them to take deductions not allowed to other taxpayers, *i.e.*, unlimited "business expense" deductions incurred in an activity not conducted for the purpose of making a profit. This contention is antithetical to the very reason for the existence of Section 512(a)(3). That provision was designed to subject social clubs to a *greater* tax burden than other tax-exempt organizations, not to give them a special tax benefit. Petitioner's interpretation is not supported by either the language or legislative history of the provision, and it was correctly rejected by the court of appeals.

1. *Section 512(a)(3) Differentiates The Tax Treatment Of Social Clubs From Other Tax-Exempt Organizations By Making Their Passive Investment Income Taxable While Preserving The Rule That Deductions Generally Available To Other Taxpayers Under Chapter 1 Of The Code May Be Taken If Directly Connected To The Taxable Activity*

Congress first imposed the "unrelated business income tax" upon tax-exempt organizations as part of the Revenue Act of 1950, ch. 994, 64 Stat. 906, in response to the concern that some of those organizations were gaining an unfair advantage from their tax-exempt status by carrying on businesses in competition with taxpaying corporations. See generally *United States* v. *American College of Physicians*, 475 U.S. 834, 837-838 (1986); *United States* v. *American Bar Endowment*, 477 U.S. 105, 109-110 (1986). The tax is imposed, at regular corporate rates, on the "unrelated business taxable income" of organizations that otherwise qualify for tax exemption. For most categories of tax-exempt organizations (but excluding social clubs), the term "unrelated business taxable income" is generally defined by Sections 512(a)(1) and 513 to mean income from a "trade or business * * * regularly carried on" that is not substantially related to the exempt purpose of the organization, reduced by deductions "allowed by this chapter which are directly connected with the carrying on of such trade or business." Section 512(b)(1) expressly excludes dividends, interest, and other investment income from the reach of the tax. The reason for this dichotomy is that passive sources of funding are not regarded as creating unfair competition with taxpaying businesses, and hence taxation of investment income would not serve the purpose for which the tax was imposed. See S. Rep. No. 2375, 81st Cong., 2d Sess. 30-31 (1950).

Social clubs were first subjected to the unrelated business income tax in 1969, when the scope of the tax was extended to virtually all tax-exempt organizations. Tax Reform Act of 1969, Pub. L. No. 91-172, § 121(a)(1), 83 Stat. 536. Congress determined, however, that social clubs should receive different, and somewhat less favorable, tax treatment than other tax-exempt organizations—specifically, that their investment income should also be taxed. Accordingly, Section 121(b)(1) of the 1969 Act (83 Stat. 537) added Section 512(a)(3), which provides a separate and more inclusive definition of "unrelated business taxable income" for social clubs and certain other tax-exempt membership groups.[8] Under that definition, a social club's "exempt function income," such as membership dues and other payments that it receives from members in exchange for rendering social and recreational services to them or their guests, is excluded from unrelated business income tax. The tax is imposed, however, on the remainder of the club's "gross income * * * less the deductions allowed by this chapter [Chapter 1 of the Code, §§ 1-1399] which are directly connected with the production of the gross income" (§ 512(a)(3)(A)). Thus, in contrast to most other tax-exempt organizations, social clubs are taxed on *all* income from nonmembership sources, whether or not produced by a trade or business; both income received from sales of goods and services to nonmembers and income from interest and dividends accruing upon the club's investments are subject to the tax. The deductions allowed to be taken from this expanded definition of gross income

[8] Under the present Code (26 U.S.C.), Section 512(a)(3) also applies to "voluntary employees' beneficiary associations" (§ 501(c)(9)), supplemental unemployment compensation benefit trusts (§ 501(c)(17)), and group legal services organizations (§ 501(c)(20)).

are analogous to those provided to other organizations—expenses may be deducted only if they are "directly connected" with the production of the taxable income and are otherwise allowable under Chapter 1 of the Code.

The reason for the distinction between social clubs and other tax-exempt organizations was explained in detail in the legislative history of Section 512(a)(3). Social clubs receive a tax exemption, not because they provide a public service to the community, but rather on the basis of their serving the mutual interests of their members. Congress has allowed the members of social clubs to pool their resources for their mutual benefit without having adverse tax consequences attach from the use of a corporation for that purpose. See generally B. Hopkins, *The Law of Tax-Exempt Organizations* 340-341 (5th ed. 1987). Profits generated by the provision of club services to members are used to benefit the members and therefore fall within the rationale of the tax exemption. But profits received from nonmember sources are an outside subsidy for the recreational activities of the members, and therefore the rationale for the tax exemption does not apply to such profits. Specifically, Congress determined that "all income [of social clubs] other than that derived from rendering services to the members" should be taxed because "where a social club has income from interest, dividends, rents, royalties, etc., this income reduces the members' costs below the actual cost of providing the personal facilities made available by the organization" (H.R. Rep. No. 413, 91st Cong., 1st Sess. Pt. 1, at 47 (1969)). The committee reports further commented that "the tax exemption operates properly only when the sources of income of the organization are limited to receipts from the membership," and characterized extension of the exemption to investment income as "a distortion

of its purposes" (*id.* at 48; S. Rep. No. 552, 91st Cong., 1st Sess. 71 (1969)).[9]

In broadening the definition of taxable income for social clubs beyond activities that qualify as a "trade or business," Congress correspondingly broadened the deductions available to social clubs as compared with those allowable to other tax-exempt organizations. It did not, however, change the *kind* of deductions that may be taken. Section 512(a)(3) allows a social club to deduct expenses directly con-

[9] The committee reports set forth the rationale for the special treatment of social clubs in considerable detail. S. Rep. No. 552, 91st Cong., 1st Sess. 71 (1969) (see also H.R. Rep. No. 413, *supra*, Pt. 1, at 48):

> Since the tax exemption for social clubs and other groups is designed to allow individuals to join together to provide recreational or social facilities or other benefits on a mutual basis, without tax consequences, the tax exemption operates properly only when the sources of income of the organization are limited to receipts from the membership. Under such circumstances, the individual is in substantially the same position as if he had spent his income on pleasure or recreation without the intervening separate organization. However, where the organization receives income from sources outside the membership, such as income from investments, * * * upon which no tax is paid, the membership receives a benefit not contemplated by the exemption in that untaxed dollars can be used by the organization to provide pleasure or recreation to its membership. For example, if a social club were to receive $10,000 of untaxed income from investments in securities, it could use that $10,000 to reduce the cost or increase the services it provides to its members. In such a case, the exemption is no longer simply allowing individuals to join together for recreation or pleasure without tax consequences. Rather, it is bestowing a substantial additional advantage to the members of the club by allowing tax-free dollars to be used for their personal recreational or pleasure purposes. The extension of the exemption to such investment income is, therefore, a distortion of its purpose.

nected with the production of all gross income (other than exempt function income), including expenses connected with activity that does not rise to the level of a trade or business. But Congress retained in Section 512(a)(3) the limitation that the permitted deductions are those "allowed by this chapter."[10] Thus, the deductions allowed in connection with the expanded definition of taxable income for social clubs are analogous to those provided to other tax-exempt organizations—expenses may be deducted only if they are "directly connected" with the production of the taxable income and are otherwise allowable under Chapter 1 of the Code. Neither Section 512(a)(1), for most tax-exempt organizations, nor Section 512(a)(3), for social clubs, independently renders deductible an expense that would not otherwise be deductible for other taxpayers under Chapter 1 of the Code. See generally 4 B. Bittker, *Federal Taxation of Income, Estates and Gifts* ¶ 102.4.4, at 102-26 (1981) (social club may deduct "otherwise allowable deductions directly connected" with production of nonexempt income).[11]

[10] This phrase is used in other provisions of Chapter 1 of the Code to incorporate by reference otherwise allowable deductions. See, *e.g.*, I.R.C. §§ 172(c) (definition of net operating loss), 183(b)(1) (activities not engaged in for profit), 280A(a) (business use of home).

[11] The impetus for the enactment of Section 512(a)(3) came in part from a recommendation by the Treasury that all of a social club's receipts from investments and nonmember activity be treated as gross income subject to the unrelated business income tax, for the reasons later reiterated by Congress in its committee reports. See Staff of House Comm. on Ways and Means and Senate Finance Comm., 91st Cong., 1st Sess., *Tax Reform Studies and Proposals, United States Treasury Department*, Jt. Publication 42, 324-325 (Comm. Print 1969) [hereinafter *Treasury Proposal*]. The provision ultimately enacted by Congress tracks the recommendations of the *Treasury Proposal* with respect to both taxable income and allow-

2. *Because Section 512(a)(3) Provides No Authority For Deductions Not Permitted In Other Contexts By Chapter 1 Of The Code, Petitioner's Excess "Business Expenses" Are Not Deductible Unless They Are Incurred In Connection With Profit-Motivated Activity*

a. The deduction provisions of Chapter 1 of the Code draw a fundamental distinction between activities that are undertaken for profit and those that are not. In effect, the Code treats a taxpayer as having two personalities—"one is [as] a seeker after profit who can deduct the expenses incurred in that search; the other is [as] a creature satisfying his needs as a human and those of his family but who cannot deduct such consumption and related expenditures." *United States* v. *Gilmore*, 372 U.S. 39, 44 (1963) (brackets in original) (quoting S. Surrey & W. Warren, *Cases on Federal Income Taxation* 272 (1960)). The Code specifically enumerates a few expenses—such as interest, taxes, and casualty losses—that can be deducted in computing taxable income even if they do not relate to profit-seeking endeavor. See I.R.C. §§ 163, 164, 165(c). Apart from specific exceptions, however, excess expenses of a not-for-profit activity cannot be applied to offset taxable income from other sources. See generally 1 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts* ¶¶ 20.1.1, 22.5.4 (1989); note 6, *supra*.

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able deductions. The *Treasury Proposal* explained (at 324-325) that deductions should be allowed only for expenses "directly connected with an activity generating income subject to tax" and indicated that the expenses would have to be "otherwise deductible" under the Code. The phrase "allowed by this chapter" embodies in Section 512(a)(3) the recommendation of the *Treasury Proposal* that expenses must be "otherwise deductible" in order to be deducted by a social club; Section 512(a)(3) does not independently allow deductions for any particular kind of expenses.

Among the most important of the provisions of Chapter 1 to which a profit-motive limitation applies is Section 162, which grants a deduction for "the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." The indicia of a "trade or business" for purposes of Section 162 include the regularity, continuity, and extensiveness of a taxpayer's commercial activities. See, *e.g.*, *McDowell* v. *Ribicoff*, 292 F.2d 174, 178 (3d Cir.), cert. denied, 368 U.S. 919 (1961). But "[i]t is well established that the existence of a genuine profit motive is the most important criterion for the finding that a given course of activity constitutes a trade or business." *Lamont* v. *Commissioner*, 339 F.2d 377, 380 (2d Cir. 1964) (citing cases); see also *Independent Elec. Supply, Inc.* v. *Commissioner*, 781 F.2d 724, 726 (9th Cir. 1986) (existence of profit motive is "primary inquiry"). Noting the "voluminous jurisprudence" to that effect, this Court has recognized that "[t]he standard test for the existence of a trade or business for purposes of § 162 is whether the activity 'was entered into with the dominant hope and intent of realizing a profit.'" *United States* v. *American Bar Endowment*, 477 U.S. at 110 n.1 (quoting *Brannen* v. *Commissioner*, 722 F.2d 695, 704 (11th Cir. 1984)). Accord, *Commissioner* v. *Groetzinger*, 480 U.S. 23, 35 (1987) ("the taxpayer's primary purpose for engaging in the activity must be for income or profit" if it is to qualify as a trade or business); see also Pet. Br. 23.[12]

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[12] Section 212, which grants individuals a deduction for expenses sustained for "the production of income," albeit not in an activity that rises to the level of a trade or business, likewise contains a profit-motive test. This Court explained in *United States* v. *Gilmore*, 372 U.S. at 46, that "the only kind of expenses deductible under [the predecessor of Section 212] are those that relate to a 'business,' that is, profit-seeking,

b. Petitioner acknowledges (Br. 10) that the expenses it treated as "directly connected" with its sales of food and drink consist almost entirely of the kind of expenses rendered deductible, if at all, by Section 162 and related provisions of the Code—*i.e.*, they are "business" expenses, such as payroll, depreciation, insurance, and cost of goods sold. See Pet. App. 11a. Under the established rules of Chapter 1, excess expenses of that kind may not be deducted from other income of the taxpayer unless they are sustained in an activity that is intended to make a profit. Section 512(a)(3) expressly incorporates the rules generally governing deductions permitted by Chapter 1, and therefore petitioner may not use excess expenses from its nonmember sales to reduce its taxable investment income, unless it engaged in that sales activity with a profit motive. No provision of the Code—neither Section 512(a)(3) nor anything elsewhere in Chapter 1—authorizes the deduction of excess "business" expenses incurred in an activity not motivated for profit.

Moreover, if this profit-motive limitation were not retained in Section 512(a)(3), the statute would not achieve its basic goal of putting the members of a social club on an equal footing with other taxpayers with respect to the club's income from sources outside the membership, specifically including income from investments. The underlying policy reason for the enactment of Section 512(a)(3) would also be defeated. If a social club could eliminate taxation of its investment income by means of a deduction that would be denied to other taxpayers—*i.e.*, a deduction

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purpose." See also *Snyder* v. *United States*, 674 F.2d 1359, 1364 (10th Cir. 1982). Section 167(a) limits depreciation deductions to property that is "used in the trade or business" or that is "held for the production of income." See, *e.g.*, *Duffy* v. *United States*, 690 F.2d 889, 901-902 (Ct. Cl. 1982).

of excess "business" expenses incurred in a not-for-profit activity—it could thereby use tax-exempt investment income to subsidize the recreational activities of the members. That is precisely the result Congress sought to avoid by enacting Section 512(a)(3) because it recognized that this would give the members of social clubs an unfair tax "advantage" over other taxpayers who, "without the intervening separate organization," must spend after-tax earnings on recreational pursuits. See H.R. Rep. No. 413, *supra*, at 48; S. Rep. No. 552, *supra*, at 71. Thus, both the language and the purpose of Section 512(a)(3) require that social clubs be subject to the same profit motive limitations that govern deductions generally made available to other taxpayers in Chapter 1 of the Code.

The courts of appeals that have construed Section 512(a)(3), with the exception of the Sixth Circuit in *Cleveland Athletic Club, Inc.* v. *United States*, 779 F.2d 1160 (1985) (see note 15, *infra*), have recognized that it should not be read to eliminate the profit motive limitation on the deductibility of "business" expenses. In *North Ridge Country Club* v. *Commissioner*, 877 F.2d 750, 754 (1989), the Ninth Circuit concluded that it would be "at odds with the language of section 512(a)(3)(A) to permit the Club to deduct losses from nonmember activities without grounding the deduction on a provision of Chapter 1 of the Code." The court explained that the only provision of Chapter 1 that could authorize deduction of the losses claimed by the club in that case—losses indistinguishable from those claimed by petitioner here—was Section 162, "which requires a profit motive." *Ibid.* And the court also observed that an interpretation that failed to retain the profit motive requirement would contravene the very purpose for enact-

ment of Section 512(a)(3) because it would confer an unwarranted tax benefit upon social clubs (*ibid.*):

> Congress sought to eliminate the differences between the tax treatment afforded individuals seeking independent recreation, and the treatment given to those seeking recreation through a social club. It is contrary to this purpose to read section 512(a) to allow social clubs to deduct losses in activities not entered into for profit, while denying individuals the same deduction.

In *The Brook, Inc.* v. *Commissioner*, 788 F.2d 833 (1986), the Second Circuit also concluded that the language and underlying policy of Section 512(a)(3) preclude a social club from reducing its investment income by the net losses generated by nonmember activity not conducted for profit. Construing the "plain language and legislative history of § 512(a)(3)(A)," the court held that a social club is "required to establish that § 162 of Chapter 1, which is incorporated by reference in § 512(a)(3)(A), authorizes its deduction from its investment income of the losses suffered from its serving of meals to non-members." 799 F.2d at 838. That requirement, the court continued, means that the expenses may be deducted "only if the taxpayer engaged in the activity with the intention of making a profit" (*ibid.*). The court further observed that the contrary interpretation "would negate Congress' express purpose that social clubs be treated neutrally with respect to their unrelated business income and neither suffer nor benefit under the Code" (*ibid.*). If Section 512(a)(3) did not include the profit motive limitation on the deductibility of "business expenses," it would grant social clubs a special tax advantage "by allowing them to take § 162 deductions unavailable to other taxpayers, *i.e.*, for expenses incurred in activities not engaged in for a profit" (799 F.2d at 839). Accordingly, the court below was entirely correct in reaffirming its prior holding in *North Ridge* that "a social club must pursue a nonmember activity with a profit motive before it can properly deduct its losses under section 512(a)" (877 F.2d at 754).

3. *Petitioner Misreads The Statute In Contending That Section 512(a)(3) Creates A Special Rule For Social Clubs That Eliminates The Profit Motive Requirement For The Deduction Of Excess "Business Expenses"*

Petitioner has not questioned that the interpretation of Section 512(a)(3) by the court below best effectuates the policy concern that led Congress to enact the provision—namely, to prevent social clubs from using tax-free investment income to subsidize their members' recreational activities. Indeed, petitioner does not appear to take issue with the Ninth Circuit's obervation in *North Ridge* that the interpretation of the statute proffered by the taxpayer in that case (indistinguishable from petitioner's) would yield "the sort of tax-free subsidy to social club members that section 512(a) sought to prevent" (877 F.2d at 756). Moreover, petitioner concedes that, under the terms of Section 512(a)(3), deductible "expenses must be of a kind which is allowed as a deduction *to a business* under Chapter 1 of the Code" (Pet. Br. 21-22 (emphasis added)), and it recognizes (*id.* at 10, 22-23) that, apart from social clubs, no taxpayer, including a tax-exempt organization governed by Section 512(a)(1) (Br. 19), is permitted to deduct excess expenses of this sort unless they are incurred in a profit-motivated activity. Petitioner's principal contention therefore (Pet. 16-35) is that, regardless of the policies underlying Section 512, the text of the statute (read literally but not "too literally" (see Pet. Br. 27, 28)) necessarily creates a unique tax benefit for social clubs—one that permits them to deduct (against unrelated investment in-

come) excess "business expenses" incurred in an activity not motivated by profit. This contention simply misinterprets the language of Section 512(a)(3); nothing in that provision, which was enacted to subject social clubs to a *greater* tax burden than other tax-exempt organizations, has the effect of conferring upon social clubs a special tax benefit not available to other taxpayers.

a. Petitioner's primary contention (Br. 16-26) is that, because Section 512(a)(3) taxes income that is derived from activity not rising to the level of a trade or business and allows associated deductions, the provision necessarily eliminates any requirement that "business" expenses actually be incurred in connection with a business, *i.e.*, a profit-motivated activity. Petitioner buttresses this contention by arguing that, because all of this nonexempt income has been classified as "unrelated business taxable income" for purposes of levying the tax, all nonexempt activities of social clubs "are by definition unrelated *business* activities" (Br. 22). "Where Congress has defined an activity as a 'business,'" petitioner continues, "there is no need to test the activity further for profit motivation" (Br. 23). Petitioner also ascribes great significance to the absence from Section 512(a)(3) of the phrase "trade or business" (Br. 23-26).

Petitioner's analysis suffers from two major flaws: First, it ignores the historical context of Section 512(a)(3) and the logical reasons why the language upon which petitioner relies was chosen; second, it disregards—indeed, nullifies—the one phrase in Section 512(a)(3) that is specifically addressed to the question of what expenses are deductible—*viz.*, "the deductions allowed by this chapter."

As we have noted (p. 15, *supra*), Congress first determined in 1950 to tax some of the income of certain tax-exempt entities. At that time, the only kind

of income taxed was income derived from a "trade or business" unrelated to the organization's exempt purposes, and that income was referred to in the statute as "unrelated business taxable income." When Congress determined in 1969 that social clubs should be taxed on a broader class of income, including investment income, it accomplished that goal within the existing statutory framework of Sections 511-513 by providing that such income "would be treated and taxed as business income" (H.R. Rep. No. 413, *supra*, at 47). The statute continues to use the term "unrelated business taxable income" to describe the taxable income of social clubs simply because that was the term historically used with respect to other tax-exempt organizations to identify the base on which the unrelated business income tax was imposed. Congress manifestly did not intend that nonbusiness activity—such as management of investments or activity not motivated by profit—would be transformed by Section 512(a)(3) into a "trade or business" for all purposes.

Similarly, the differences in language between the definitions of taxable income for social clubs (§ 512(a)(3)) and for other tax-exempt organizations (§ 512(a)(1)) do not operate to eliminate for social clubs the profit motive requirement for the deduction of "business expenses." Prior to 1969, only income derived from a "trade or business" was subject to the unrelated business income tax. It logically followed that the only allowable expense deductions should be for those "connected with the carrying on of such trade or business," as Section 512(a)(1) provided. The motivation for enacting Section 512(a)(3) was to expand for social clubs the kinds of income that would be subject to taxation; once the source of taxable income was no longer restricted to that derived from a "trade or business," Congress naturally also

removed the restriction that deductions be connected to a "trade or business." But while this change allowed social clubs to deduct from their nonbusiness income expenses that the Code generally allows other taxpayers to deduct from such income (*e.g.*, certain taxes and interest), it plainly was not designed to give social clubs the right to deduct excess "business" expenses connected with nonbusiness (*i.e.*, not-for-profit) activity.[13] As the Second Circuit stated in *The Brook*, 799 F.2d at 841, "it may not * * * be inferred from the difference in language between § 512(a)(1) and § 512(a)(3) that Congress intended social clubs to be relieved from the requirements of § 162 so that they would receive an advantage over other taxpayers claiming deductions under that provision." Rather, "the difference is rooted in Congress' intent to tax entities such as social clubs more comprehensively than charitable and religious organizations, which are dedicated to more altruistic purposes." *Id.* at 840; see also *North Ridge*, 877 F.2d at 753-754.[14]

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[13] The legislative history cited by petitioner (Br. 20-21) adds nothing to its argument based on the statutory language. The language quoted from the House Report and from the *Treasury Proposal* merely helps to confirm what is undisputed —namely, that Congress sought to expand the definition of taxable income for social clubs to include income from activities that do not rise to the level of a "trade or business," and to allow the deduction of expenses directly connected with those nonbusiness activities, so long as the expense is "otherwise deductible" (*Treasury Proposal* at 325), *i.e.*, allowed by Chapter 1 of the Code. As the Ninth Circuit noted in *North Ridge*, the Treasury's explanation "clearly does not say that deduction of *losses* is proper even if the non-member activity was not entered into for profit" (877 F.2d at 755).

[14] Petitioner's argument that it is "unfair" to tax a social club on its nonbusiness income, and then confine its deductions to trade or business deductions (see Pet. Br. 27), is misconceived. The deductions allowed by Section 512(a)(3) are properly tailored to the income subjected to tax. See *The Brook*, 799 F.2d at 841. Petitioner is permitted the full range of deductions, business and nonbusiness, that are authorized by the Code and connected with the production of its nonexempt income. The expenses whose deductibility is in question here, however—namely, the allocable expenses of petitioner's nonmember sales in excess of gross receipts—are of the kind allowed, if at all, only by Section 162. They accordingly must meet the requirements of that provision, which means that they must be incurred in a profit-motivated activity, in order to be allowable under Section 512(a)(3).

Moreover, by expressly limiting deductions under Section 512(a)(3) to those "allowed by this chapter," Congress ensured that social clubs could not take deductions against their nonexempt income that would be unavailable to other taxpayers—including deductions for "business expenses" not incurred in a profit-motivated activity. Although petitioner has conceded that the requirement that deductions be "allowed by this chapter" is one "prong" of a "two prong" test under Section 512(a)(3) (see Pet. Br. 21-22), petitioner's theory would effectively nullify that requirement. Under petitioner's reading of the statute, *every* ordinary and necessary expense connected with the production of a social club's nonexempt income would automatically be converted into a deductible business expense that satisfies the "allowed by this chapter" limitation, irrespective of whether the expense would qualify for deduction under Section 162 or another provision of Chapter 1. A test that is always satisfied is no test at all. Furthermore, petitioner's interpretation would violate what it concedes is one of the basic commands of Section 512(a)(3)—that a social club's nonexempt activities "are subject to tax in the same manner as any taxable business is taxed" (Pet. Br. 20). In sum, both the statutory text and its underlying policy

are inconsistent with petitioner's contention that Section 512(a)(3) excuses social clubs from the general rule that "business expenses" may be deducted only if incurred in connection with a profit-motivated activity.[15]

b. Petitioner contends (Br. 29-32) that Section 512(a)(3) contemplates that a social club should "aggregate" its expenses, instead of breaking them down on an activity-by-activity basis, and therefore that net losses from its nonmember sales automatically reduce its investment income, without the need for any inquiry into profit motive. Otherwise, petitioner maintains, social clubs would be disadvantaged in comparison with nonexempt taxpayers who allegedly "are allowed to deduct net losses from one business activity against net income from a different business activity" (Br. 30). As an example, petitioner invokes the case of a gambling establishment that consistently incurs losses from serving food and drink to patrons of the casino: the business would not be prevented from offsetting those losses against its casino income. This argument is misconceived.

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[15] Significantly, even petitioner recognizes (Br. 27-29) that some kind of profit motive requirement—that receipts exceed variable costs (which it terms "economic gain")—must be embodied in Section 512(a)(3) in order to avoid eviscerating the statutory purpose. Accordingly, petitioner cautions against reading the statute "too literally" (Br. 27, 28), embracing the Sixth Circuit's holding in *Cleveland Athletic Club* v. *Commissioner*, *supra*, that all expenses incurred in an activity intended to produce this kind of "economic gain" are deductible under Section 512(a)(3). See 779 F.2d at 1165. In our view, the imposition of this "economic gain" requirement (or defining "profit" under Section 162 in terms of "economic gain," which leads to the same result (see point B, *infra*)) does not prevent petitioner's interpretation from doing violence to the congressional intent. In any event, petitioner's theory is not consistent with the statutory text.

Contrary to petitioner's contention, the decision of the court of appeals does tax social clubs on their nonexempt income according to the same rules that apply to other taxpayers. The reason that a gambling casino is able to deduct excess expenses of its food and bar service is because of the close business connection with its gambling operations; the food service is designed to facilitate the production of income from the gambling operation. In short, the two activities should not be viewed separately; they are part and parcel of the same business. By contrast, there is no connection between petitioner's meal service and the production of the interest income that accrues upon its investments. Where there exists a sufficient nexus, losses from one component of an activity appropriately can be netted against gains from another component of the same activity without examining each separately for profit-motivation. Cf. Treas. Reg. § 1.183-1(d)(1) (operations bearing sufficient "economic interrelationships" comprise one "activity" for purposes of combining gains and losses); 1 B. Bittker & L. Lokken, *supra*, at ¶ 22.5.3. Because petitioner's sale of food and drink to nonmembers constitutes an entirely separate activity from its receipt of income from a savings account, this kind of netting to enable petitioner to shelter its investment income is improper.

More generally, neither the statute (see Pet. Br. 25 & n.15) nor the Commissioner's proposed regulation concerning social clubs (see Pet. Br. 30-32) supports petitioner's contention that expenses are to be aggregated in a way that does not require consideration of profit motive. Prop. Treas. Reg. § 1.512(a)-3(b), 36 Fed. Reg. 8806 (1971) (which petitioner concedes had no force or effect (see Pet. Br. 32 n.23) and has been withdrawn), stated that the unrelated business taxable income of a social club

deriving income from more than one source "is computed by aggregating its gross income from all such sources and by aggregating its deductions *allowed* with respect to such gross income" (Prop. Treas. Reg. § 1.512(a)-3(b)(3) (emphasis added)). Because the proposed regulation addressed the aggregation only of deductions that are "allowed," it did not suggest that petitioner could mingle losses from its nonmember sales activity together with income from its investments, if the sales activity were not engaged in with a profit motive. In accordance with the text of the statute, the word "allowed" in the proposed regulation must be read in the context of the regulation's general statement that, "to be deductible in computing unrelated business taxable income [under Section 512(a)(3)], expenses, depreciation, and similar items * * * must qualify as deductions under chapter 1 of the Code" (Prop. Treas. Reg. § 1.512(a)-3(b)(1)). See also Prop. Treas. Reg. § 1.512(a)-3(b)(2) (expense must be "otherwise allowable under chapter 1 of the Code"). Unless petitioner's nonmember sales activity is carried on with an intent to make a profit, the expenses allocated to that activity are "allowed" only to the extent of offsetting the income that it produces; no excess expenses are "allowed" to be deducted and hence there is no available loss that can even enter into the aggregation process. See *The Brook*, 799 F.2d at 838 (social club is entitled to "aggregate deductions * * * as permitted by § 162 to other taxpayers"); *North Ridge*, 89 T.C. at 571-572 (social club's income production must be broken down on activity-by-activity basis so that profit motive for each activity can be determined).[16]

[16] There is similarly no merit to petitioner's assertion (Br. 26 & n.16) that the computation of a social club's unrelated business taxable income from nonmember sales activity "becomes impracticable" if a profit motive test is imposed on the allowance of deductions. The computation of the taxable income from nonmember sales is essentially a two-step process. First, the club computes the expenses "directly connected with" the production of income from the sales; this may require an allocation of fixed expenses, which in this case was made using a gross receipts method. Second, the expenses must be examined to determine whether their deduction (in excess of the gross income from the sales) is "allowed by this chapter." This determination requires resolving whether the sales activity is motivated by profit. This two-step procedure is eminently practicable as a matter of computation; indeed, this procedure is required to implement the "two prong test" that petitioner concedes to be established by Section 512(a)(3) (see Pet. Br. 21-22).

Finally, petitioner argues (Br. 33) that it is irrational to prevent it from deducting, even for the purpose of sheltering investment income, all of the expenses that it allocates to its nonmember sales because those expenses "are the ordinary and necessary costs of generating the economic gains which were provided by the unrelated business activities." This description obscures the true effect of petitioner's claimed deduction and the extent to which it subverts the statutory purpose. The Commissioner *does* allow petitioner to offset the ordinary and necessary costs of generating "economic gains" against its nonmember sales receipts. So long as the gross receipts do not exceed the costs of that activity, the Commissioner would not require petitioner to recognize any net income from the activity and would not collect any tax upon it. But petitioner is not satisfied with this tax treatment. Petitioner seeks to use the allocated fixed costs not simply to offset its income from the activity, but rather to generate "tax losses," which it can then use to offset its unrelated investment income. A deduction of that sort must be authorized by Section 162, which means that the ac-

tivity generating the losses must be conducted with a profit motive.

B. An Activity Is Not Motivated By Profit When It Is Not Intended That The Gross Receipts From That Activity Will Exceed The Expenses Properly Allocable To It, Both Fixed And Variable

Petitioner's secondary argument (Br. 35-48) is that, even if a profit motive is required for it to deduct the excess expenses of its nonmember sales, it has demonstrated such a profit motive because it intended the nonmember activity to produce "economic gain"—defined as gross receipts in excess of variable costs of the activity. In other words, petitioner argues that, even though it has allocated a portion of the fixed expenses to its nonmember sales in order to generate steady losses (totalling more than $400,000 for the years 1974-1984 (J.A. 91)), those expenses can be completely disregarded in testing the nonmember sales activity for the profit motive necessary to establish deductibility because the fixed expenses would be incurred even if there were no nonmember sales activity.

The court of appeals correctly rejected this contention. The established approach for determining profit motivation in resolving whether an activity is a "trade or business" is to compare gross receipts with *all* properly allocated expenses, fixed as well as variable. There is no support for petitioner's assertion that the profit motive inquiry should exclude one segment of the economic costs of producing income—the allocable portion of fixed costs.

Indeed, petitioner's argument rests on an inherent contradiction. The net losses reported from the nonmember sales that petitioner seeks to offset against its investment income result from petitioner's allocation of a portion of the fixed expenses as "directly connected" to that nonmember activity (I.R.C.

§ 512(a)(3)). If these expenses are directly connected to the production of nonmember income, there is no logical justification for excluding them from the cost calculation when trying to determine whether that activity is profit-motivated. Finally, allowing petitioner to manipulate the fixed expense allocation in this manner would eviscerate the effectiveness of the statute. Petitioner's argument would make it relatively easy for any social club to allocate fixed expenses to nonmember activity so as to generate net losses from that activity that could then be used to eliminate the tax on the club's investment income.

1. Petitioner's interpretation of profit motive finds no support in other contexts. The standard approach for deciding whether an activity is conducted with the profit motivation required to constitute a "trade or business" is to measure gross receipts against *all* of the expenses of the activity, drawing no distinction based on whether the expenses are fixed or variable. On many occasions, the courts of appeals have identified "profit" for these purposes with "taxable income," which necessarily contemplates reduction of gross income by both fixed and variable expenses. In *Hirsch* v. *Commissioner*, 315 F.2d 731, 736 (1963), the Ninth Circuit observed that the primary inquiry when determining whether a particular activity constitutes a trade or business under Section 162 is whether it was "entered into, in good faith, with the dominant hope and intent of realizing a profit, i.e., taxable income, therefrom." Accord, *Independent Elec. Supply, Inc.* v. *Commissioner*, 781 F.2d at 726; *Bessenyey* v. *Commissioner*, 379 F.2d 252, 256 n.5 (2d Cir.), cert. denied, 389 U.S. 931 (1967); *Weir* v. *Commissioner*, 109 F.2d 996, 998 (3d Cir.), cert. denied, 310 U.S. 637 (1940). Similarly, in *Miller* v. *Commissioner*, 836 F.2d 1274, 1278-1279 (1988),

the Tenth Circuit reasoned that the phrase "transaction entered into for profit" in Section 165(c) of the Code connotes "an ultimate objective of producing taxable income." And numerous decisions construe the business deduction provisions of the Code to disallow, for failure to satisfy the profit motive requirement, losses from activities that produce some gross income, but not enough to recoup all the related expenses. See *The Brook*, 799 F.2d at 838-840 (collecting cases).

The salient feature of this case is that, according to petitioner's reported allocation, the fixed expenses are incurred in connection with two very different purposes—primarily in connection with the exempt purpose of furthering the social and recreational interests of the club's members, and partially in connection with the nonmember sales. The primary reason for the nonmember sales activity is to produce a positive "cash flow" (an excess of gross receipts over the extra expenses occasioned by the sales) that will help to defray some of the fixed costs that are being incurred anyway. See Pet. Br. 38-39, 46-47. This situation is closely analogous to the relatively common "dual use" situation where fixed overhead may be regarded as being expended both for personal reasons and for income production. There are many cases where a taxpayer owns property (such as a farm, yacht, or vacation home) primarily for personal reasons, but in order to defray the expenses of its maintenance, he also puts the property to use in an income-producing activity. In these "dual use" or "hobby" cases, the secondary activity will help defray expenses by bringing in gross income that exceeds the variable costs of conducting that activity; typically, however, the income will not be sufficient to cover the sum of the variable expenses and an allocable portion of the fixed expenses that might be reported as directly connected

with the income-producing activity. In such a situation, an individual may offset the expenses of the secondary activity against the income it produces, but he may not deduct any excess expenses if the activity is "not engaged in for profit." See I.R.C. § 183(a) and (c).

There is no authority suggesting that the portion of the fixed expenses allocated to the income-producing activity may be ignored in determining whether the activity is engaged in with an intent to make a profit, on the ground that those expenses would have been incurred by the taxpayer anyway in the absence of the income-producing activity. To the contrary, because the tax law draws a fundamental distinction generally allowing deduction of business expenses while precluding deduction of personal expenses, the nonbusiness origin of those allocated fixed expenses strongly suggests that they must be taken into account in making a profit motive determination that will decide their deductibility. For example, in *Carkhuff* v. *Commissioner*, 425 F.2d 1400 (6th Cir. 1970), the court rejected the taxpayers' attempt to offset against other income losses generated by depreciation deductions on a vacation home that was rented for part of the year. The court acknowledged that the purpose of renting could have been to "minimiz[e] the cost of maintaining a resort home" (*id.* at 1405), but it held that this desire to produce a positive cash flow did not demonstrate a "profit motive". See also *Carter* v. *Commissioner*, 645 F.2d 784, 789 (9th Cir. 1981) (although taxpayers chartered yacht in an "attempt[] to recoup some of their costs," that does not constitute profit motive); *Antonides* v. *Commissioner*, 893 F.2d 656, 660 (4th Cir. 1990), aff'g 91 T.C. 686, 697 (1988); *Martin* v. *Commissioner*, 50 T.C. 341, 364 (1968) (same); cf. also I.R.C. § 280A (limiting deduction of

expenses connected with rental of vacation home). Thus, a mere intent to produce gross receipts in excess of variable costs is insufficient to establish a "profit motive." If the rule were otherwise, there would be a large loophole in the Code enabling individuals to use what are primarily personal expenses to shelter taxable income.[17]

Accepting petitioner's interpretation of profit motive in this context would open the same kind of loophole in the taxation scheme for social clubs. Petitioner has received income from its investments that is presumptively subject to taxation. Petitioner then engages in another activity, sales of food and drink to nonmembers, that assertedly is designed to defray the costs of operating the club. Although this activity brings additional funds into the club's coffers (see Pet. Br. 47), petitioner maintains that the tax effect of this additional infusion of funds is to *eliminate* any tax on the investment income. This is accomplished by deducting against the investment income

[17] For example, suppose an individual, who still receives substantial income from an annuity, retires to live on a large farm where he raises horses for pleasure. Though he undisputedly does not raise the horses to make a profit, he does engage in one activity to defray some of the expenses of the operation. On several occasions during the year, the taxpayer allows schools and summer camps to bring their students to visit the farm and pet the horses. The taxpayer charges the organizations a fee for the right to visit. Although the fee is relatively modest, it exceeds the minimal variable costs of the activity, which consist of hiring one college student per visit to keep an eye on the group. Under petitioner's interpretation of profit motive as "economic gain," the taxpayer in this example could claim that he operates his "horse petting" activity with a profit motive and then could reduce his annuity income by an allocable share of the substantial costs of raising the horses.

fixed overhead expenses that petitioner acknowledges are incurred in order to further the club's recreational activities, and would be incurred irrespective of the club's nonmember activity. Section 512(a)(3) does not permit this untoward result because "profit motive" means an intent that an activity produce an excess of gross income over all the expenses properly allocated to the activity. To the extent that an allocable portion of petitioner's fixed expenses is "directly connected" to its nonmember activity so as to warrant offset against the gross income generated by that activity, those expenses must also be considered in determining whether that activity was engaged in with the requisite profit motive. See *North Ridge*, 877 F.2d at 754; *The Brook*, 799 F.2d at 839 ("The mere fact that hobbies generate receipts, or 'economic gain', does not entitle them to § 162 tax treatment.").[18]

[18] Indeed, even the Sixth Circuit's decision in *Cleveland Athletic Club* appears to recognize that petitioner errs in generally interpreting "profit motive" to mean an excess of gross receipts over variable costs. The court there stated that "the challenged deductions need not necessarily come within the § 162 trade or business allowance, but rather, the deductions are allowable as ordinary and necessary to the production of income with a basic purpose of economic gain" (779 F.2d at 1165). Thus, the court did not rule for the taxpayer because it thought that an intent to produce "economic gain" satisfies the profit motive standard of Section 162; instead, it held that, because Section 512(a)(3) does not contain the phrase "trade or business," there is a special rule for social clubs that permits them to deduct expenses incurred with the intent of producing income in excess of variable costs. See 779 F.2d at 1165. As we have explained (pp. 27-30, *supra*), the Sixth Circuit misinterpreted Section 512(a)(3) in this regard because omission of the phrase "trade or business" was integral to accomplishing the purpose for which the provision was enacted; it was not designed to, nor does it in effect, allow a social club to take a deduction not otherwise allowable to

2. Petitioner errs in asserting (Br. 39-42) that its position is supported by a line of cases stating that the "profit motive" inquiry should be based on the intent to earn an "economic profit." Despite the superficial similarity between the language used in those cases, which almost all concern tax shelters, and the term "economic gain" that petitioner uses here, the concepts are quite different. It is, to be sure, well established that a taxpayer's profit motive must be demonstrated in terms of "economic profit"—in the sense that accompanying tax benefits are not relevant. Thus, in the tax shelter context, where a motive to achieve "economic profit" must be shown in order to offset a loss against other income, the taxpayer must have intended his investment to yield profits apart from the tax benefits generated by the shelter itself (in the form of claimed deductions for economic losses).[19] But those cases do not suggest that fixed expenses are to be disregarded in determining whether

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other taxpayers under the Code. The Tax Court in *North Ridge*, on the other hand, did accept petitioner's position that profit motive is to be determined by comparing gross receipts with variable costs. 89 T.C. at 572-573. The court cited no authority and did not elaborate on its conclusion.

[19] See, *e.g.*, *Simon* v. *Commissioner*, 830 F.2d 499, 500 (3d Cir. 1987) ("'profit' means economic profit independent of tax savings"); *Gefen* v. *Commissioner*, 87 T.C. 1471, 1490 (1986) ("A transaction has economic substance and will be recognized for tax purposes if the transaction offers a reasonable opportunity for economic profit, that is, profit exclusive of tax benefits."); *Waddell* v. *Commissioner*, 86 T.C. 848, 894 (1986) ("taxpayers were just buying tax deductions, not entering into economically motivated investments"); *Estate of Baron* v. *Commissioner*, 83 T.C. 542, 560 (1984) (inquiry into "economic consequences of the transaction aside from its tax benefits"); Treas. Reg. § 1.512(a)-1(f)(7)(ii)(b) (activity "will result in economic profit (without regard to tax consequences)").

an activity is conducted for "economic profit." Indeed, those cases do not even arise in a "dual use" situation, which is essentially the only context in which the distinction petitioner seeks to draw between fixed and variable expenses would be significant for tax cases. Thus, the authority relied upon by petitioners has no bearing on the question presented here.[20]

Petitioner erroneously contends (Br. 43-46) that the court of appeals' interpretation of "profit motive" is inconsistent with the fact that many business corporations report large losses on their tax returns while realizing substantial book profits. But, in contrast to this case, such losses do not reflect the economic costs of the activity in question, but rather the operation of various tax preferences specifically provided by Congress in the Code. The corporate losses cited by petitioner result from accelerated depreciation, investment tax credits, and other tax pref-

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[20] By the same token, the IRS's ruling addressing this issue, Rev. Rul. 81-69, 1981-1 C.B. 351, in referring to the "cost of sales" does not distinguish between fixed and variable costs. Cf. Pet. Br. 42. Quite apart from the fact that the Commissioner is the best judge of the meaning of his own rulings and regulations (see, *e.g.*, *National Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472, 484 n.19 (1979)), there is no basis for failing to read the ruling as stating that a deduction must be denied where a social club does not intend its gross income from nonmember sales to exceed *all* the costs of those sales. Every court that has considered the ruling has so construed it. See *The Brook*, 799 F.2d at 835-836 & n.4; *Cleveland Athletic Club*, 779 F.2d at 1165-1166. Rather than looking to the dictionary to define "cost of sales" (see Pet. Br. 42 n.45), petitioner should look to its own representations on which its claim for deduction rests—namely, that the allocated fixed costs here were the "ordinary and necessary costs" of producing the nonmember sales income (*id.* at 33).

erences and incentives. See Citizens for Tax Justice, *130 Reasons Why We Need Tax Reform* 8-10 (July 1986). The policy underlying such tax incentives is to stimulate investment and business enterprise by enabling a taxpayer to report a smaller profit (or larger loss) in a given year than it actually experiences in economic terms; indeed, petitioner recognizes that such deductions used by corporations to generate tax losses do not "accurately measure net income" (see Pet. Br. 44 n.47). For example, accelerated depreciation may allow the cost of property to be recovered, in the initial years after the property is placed in service, faster than the property in fact wears out or becomes obsolete, thus permitting a taxpayer to show a tax loss in a year in which an investment produces "a positive cash flow" or is "economically profitable." S. Rep. No. 552, *supra*, at 212; see H.R. Rep. No. 658, 94th Cong., 2d Sess. 30-31 (1976).[21]

[21] Moreover, many of these tax incentives operate only to effect a deferral, rather than a permanent reduction, in taxes. For example, accelerated depreciation provides a special tax benefit only in the early years of a property's life; as the property ages, there arrives a crossover point at which accelerated depreciation begins to provide a smaller annual deduction than would have been available under straight-line depreciation (which is supposed to reflect the true economic depreciation). Thus, tax losses in early years may be counterbalanced by gains in later years, so that the total taxable income reported over time remains unaffected. In addition, some of the tax savings otherwise provided by such tax shelter items is currently subject to recapture through the minimum tax imposed by 26 U.S.C. 56 and 57. See Pet. Br. 43-44. In petitioner's case, however, the deductions that generate the tax losses it reports from its nonmember activity are not subject to recapture and do not merely reflect deferral of taxation. If petitioner continues to allocate a portion of its fixed expenses to nonmember sales as it has done in the

Thus, these examples are fully consistent with the decision of the court of appeals that "profit motive" must be determined by taking into account all of the economic costs associated with the activity--both fixed and variable. The losses reported on petitioner's tax return do not stem from tax preferences not designed to reflect net income; rather, they stem from standard "business expenses," such as payroll, cost of goods sold, insurance, and the like. See J.A. 52-59, 64-65, 69-72.[22] Since petitioner does not intend to receive gross income in excess of these basic economic costs of its nonmember sales, it does not conduct that activity with the kind of "profit motive" needed to allow deduction of business expenses.[23]

tax years at issue here, it likely will report losses from that nonmember activity forever. See J.A. 63.

[22] No commercial establishment would stay in business if it continued indefinitely to sustain losses of the magnitude claimed by petitioner year after year. The "economic gain" (*i.e.*, excess of gross receipts over variable costs) to which petitioner points would not be generated if an unsubsidized commercial establishment operated petitioner's nonmember activity. The apparent gain is achieved only by ignoring the fixed overhead, *i.e.*, by treating the commercial nonmember operation as being able to use the premises without paying any rent, insurance, etc. Clearly, it is not appropriate to calculate petitioner's tax liability on the assumption that nonexempt activity will be subsidized in this manner by the club, when the original impetus for the enactment of the unrelated business income tax was to prevent tax-exempt organizations from using their exemption to subsidize unrelated business activity. Thus, looking at the nonmember operation as if it were a private operation, it is apparent that it is not organized and operated in a way that it can make a profit.

[23] Petitioner also suggests (Br. 34-38) that the question of "profit motive" in this case is a factbound one, and that the

3. Petitioner's position with respect to the meaning of "profit motive" rests on an inherent contradiction, and should be rejected for that reason alone. Petitioner asserted on its tax returns that the allocated portion of its fixed expenses were "directly connected with" (I.R.C. § 512(a)(3)) the production of gross income from the nonmember sales. In petitioner's words, those were "the ordinary and necessary costs of generating" the income (Br. 33). When it comes to the profit motive inquiry, however, petitioner ignores those expenses—*i.e.*, it maintains that, despite the nonmember activity, the fixed expenses were sus-

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court of appeals impermissibly interfered with the Tax Court's discretion to consider the "facts and circumstances" of each case. This is mistaken. The extent to which a taxpayer operates an activity in a professional manner (see Pet. Br. 36-37) can be a relevant factor in a case where it is not otherwise apparent whether the activity was intended to produce a profit. But if it is apparent that the taxpayer does not intend to produce a profit, there is no "profit motive" regardless of how the operation was run. Here, there is no dispute over the material facts. Sales of food and drink to nonmembers were priced at a level "intended to result in profit to the club over the direct cost associated with the activity" (Pet. App. 20a-21a). On the other hand, when the *total* costs allocated to the activity are considered, petitioner reported a substantial loss every year totalling more than $400,000 over an 11-year period (J.A. 91), and there has never been any suggestion that petitioner intended to bring in gross receipts that would exceed these total costs. Thus, the Tax Court's conclusion that the profit motive standard was satisfied did not turn on any factual findings; rather, it turned entirely on the legal question of the correct definition of "profit" for these purposes. The Ninth Circuit correctly concluded that the Tax Court had evaluated uncontroverted facts according to an incorrect legal standard. See *North Ridge*, 877 F.2d at 755.

tained solely in connection with petitioner's recreational and member functions.[24]

Petitioner is simply trying to have it both ways—insisting that these fixed costs are actual expenses of its nonexempt activity when it wants to offset the gross receipts from that activity, and then in turn denying that these fixed costs are actual expenses when it wants to demonstrate that it intends the gross receipts from that activity to exceed expenses (a prerequisite to deducting the excess expenses against unrelated investment income). There is no reason to countenance this manipulation of the fixed expenses to generate either "profits" or "losses," at

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[24] There may be room to debate whether the fixed costs allocated by petitioner to its nonmember sales constitute true economic costs of that activity that ought to be treated as "directly connected" to the production of the nonmember sales income. It might be argued that only the variable costs are "directly connected with" the nonmember activity, and therefore that only those variable costs should offset the gross receipts from the nonmember income. Cf. *North Ridge*, 89 T.C. at 573 & n.18. That approach would tend to increase the tax on a social club's nonexempt income by reducing the costs that could be used to offset the nonmember receipts. Petitioner and other social clubs, however, have maintained that an allocable portion of the fixed costs should be treated as "directly connected" with the production of the nonmember income, and the Commissioner has acquiesced in that treatment. Not satisfied with eliminating all tax liability for its nonmember sales, petitioner now seeks to eliminate any tax liability for its unrelated investment income as well—by manipulating its characterization of the fixed expenses. But having identified these costs as "directly connected," *i.e.*, as genuine economic costs associated with the nonmember activity—a position that is critical to its deduction claim—petitioner should not be permitted to reverse its field and disregard these costs in determining the existence of a profit motive.

petitioner's whim; either the allocated fixed costs are directly connected, ordinary costs of generating the income from the nonmember activity or they are not. Indeed, petitioner's attempt to ignore the fixed expenses in the profit motive determination is particularly inappropriate in this context where those are the very expenses whose deductibility turns on the question of profit motivation. If the costs are connected with the nonmember activity for purposes of generating the reported net losses, they must also be connected with the activity for purposes of determining whether petitioner contemplated that the activity would produce profits or losses, which in turn determines whether the reported losses can be used to offset unrelated income.

Petitioner's interpretation of profit motive would essentially defeat the statutory purpose of taxing the investment income of social clubs. Every social club has fixed overhead, and many clubs provide food and drink or other goods or services to nonmembers—at prices that exceed variable costs but do not exceed the sum of the variable and fixed costs that can reasonably be allocated to such activity. If petitioner were correct that fixed costs may be used to generate tax losses and then ignored in determining profit motive, it would be easy for social clubs to use this kind of nonmember activity to convert their normal overhead, incurred for "pleasure, recreation, and other nonprofitable purposes" (I.R.C. § 501(c)(7)), into tax-deductible losses that would eliminate the tax on their investment income. See *North Ridge*, 877 F.2d at 756; *The Brook*, 799 F.2d at 840. This result would effectively insulate the investment income of most social clubs from taxation, thereby reinstating the very problem that Section 512(a)(3) was enacted to solve. See pp. 17-18, *supra*.[25]

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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[25] Petitioner suggests (Br. 47-48) that, even if the court of appeals' analysis of profit motive is correct, this Court should nonetheless reverse the judgment below because the Tax Court found that, if a different method were used to allocate fixed expenses, petitioner could show that the receipts from nonmember sales were intended to exceed the total costs of the activity. We submit that this argument is untenable basically for reasons discussed above (see pp. 44-46, *supra*); in using different methods of allocation for different purposes, petitioner would be asserting that the same fixed costs are connected to nonmember activity when it wants to generate tax losses and are connected to exempt activity when it wants to show the possibility of profit from the nonmember activity. In any event, it would clearly be inappropriate for this Court to rule for petitioner on this theory when the court of appeals declined to rule upon it; instead, the court below appears to have left it open to petitioner to make this argument in the Tax Court on remand. See note 7, *supra*.

APPENDIX

The Internal Revenue Code (26 U.S.C.), as in effect for the years 1980 and 1981, provides in pertinent part:

Sec. 511. Imposition of tax on unrelated business income of charitable, etc., organizations

(a) Charitable, etc., organizations taxable at corporation rates

(1) Imposition of tax

There is hereby imposed for each taxable year on the unrelated business taxable income (as defined in section 512) of every organization described in paragraph (2) a tax computed as provided in section 11. In making such computation for purposes of this section the term "taxable income" as used in section 11 shall be read as "unrelated business taxable income".

(2) Organizations subject to tax

(A) Organizations described in sections 401(a) and 501(c)

The tax imposed by paragraph (1) shall apply in the case of any organization (other than a trust described in subsection (b) or an organization described in section 501(c)

(1) which is exempt, except as provided in this part or part II (relating to private foundations), from taxation under this subtitle by reason of section 501(a)

• • • • •

Sec. 512. Unrelated business taxable income

(a) Definition

For purposes of this title—

(1) General rule

Except as otherwise provided in this subsection, the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

* * * * *

(3) Special rules applicable to organizations described in section 501(c)(7) or (9)

(A) General rule.

In the case of an organization described in section 501(c)(7) or (9), the term "unrelated business taxable income" means the gross income (excluding any exempt function income), less the deductions allowed by this chapter which are directly connected with the production of the gross income (excluding exempt function income), both computed with the modifications provided in paragraph (6), (10), (11), and (12) of subsection (b). For purposes of the preceding sentence the deductions provided by sections 243, 244, and 245 (relating to dividends received by corporations) shall be

treated as not directly connected with the production of gross income.

(B) Exempt function income

For purposes of subparagraph (A), the term "exempt function income" means the gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members or their dependents or guests goods, facilities, or services in furtherance of the purposes constituting the basis for the exemption of the organization to which such income is paid. Such term also means all income (other than an amount equal to the gross income derived from any unrelated trade or business regularly carried on by such organization computed as if the organization were subject to paragraph (1)), which is set aside—

(i) for a purpose specified in section 170(c)(4), or

(ii) in the case of an organization described in section 501(c)(9), to provide for the payment of life, sick, accident, or other benefits,

including reasonable costs of administration directly connected with a purpose described in clause (i) or (ii). If during the taxable year, an amount which is attributable to income so set aside is used for a purpose other than that described in clause (i) or (ii), such amount shall be included, under subparagraph (A), in unrelated business taxable income for the taxable year.

☆ U. S. GOVERNMENT PRINTING OFFICE: 1990 262203 836

Supreme Court, U.S.
FILED
APR 10 1990
JOSEPH F. SPANIOL, JR.
CLERK

No. 89-530

IN THE
Supreme Court of the United States
OCTOBER TERM, 1989

PORTLAND GOLF CLUB,
Petitioner,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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REPLY BRIEF FOR PETITIONER

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---

REPLY BRIEF FOR PETITIONER

ARGUMENT

I. SECTION 512(a)(3) DEEMS UNRELATED EXPENSES TO BE "BUSINESS" IN CHARACTER.

A. The Government's position seeks inconsistently to tax all unrelated business income but allows deductions for only part of the unrelated business expenses.

The Government complains that Petitioner seeks a "unique" deduction for social clubs, which conflicts with Congress' intent in Section 512(a)(3) to impose higher tax burdens on clubs. (G.Br. 12-14, 22-23, 25, 35, 46.) But the fact is that Section 512(a)(3) is a "unique" statute that broadens the definition of unrelated business taxable income and deductible expenses beyond the definition provided in the general rule applicable to most tax exempts and beyond the definition generally used for tax-

able entities. The Treasury proposed Section 512(a)(3) and Congress adopted its proposal substantially unchanged. Petitioner is not to blame, for Congress intentionally adopted the special definition found in Section 512(a)(3) in order to subject to tax all the net unrelated income of a social club or a VEBA, not just its net income from an unrelated trade or business (as defined in Section 513) regularly carried on.

In broadening the income subject to tax beyond the normal boundaries of a trade or business, Congress also broadened the deductible expenses beyond the normal boundaries of a trade or business. This is clear from both the statutory terms and the legislative history. (See Pet. Br. 16-21.) However, the Government is unhappy with the results of Section 512(a)(3) and its broad definitional provisions; it erroneously attempts to expand taxable unrelated income through the Section 512(a)(3) definition, while narrowing the deductible expenses to those allowed under Section 512(a)(1) by the application of the profit motive test.

Apparently relying on the "allowed by this chapter" phrase in Section 512(a)(3), the Government seeks (G.Br. 20-21) to reintroduce the profit motive requirement, either through Section 162 or some alleged "common law" of taxation. But it is contradictory to conclude that the specific language of Section 512(a)(3) eliminates the trade or business (and included profit motive) requirement by defining the activity as a business, and then reintroduces that requirement through a broad reading of the general phrase "allowed by this chapter." Contrary to the Government's contention (G.Br. 22), the profit motive requirement of Section 162 is frequently modified by other provisions of the Code.[1] The words

[1] *E.g.*, *Frank* v. *United States*, 577 F.2d 93 (9th Cir. 1978) (IRC § 7701(a)(26) eliminates § 162 profit requirement for certain officials); *Trustees of Graceland Cemetery Improvement Fund* v. *United States*, 515 F.2d 763 (Ct.Cl. 1975) (nonprofit organization need not always have profit motive for § 162 deduction); *Golden Rule Church Assn.* v. *Commissioner*, 41 T.C. 719, 728-731 (1964) (activity may be "trade or business for purposes of Treas. Reg. § 1.501(c)(3)-1(e) even though it is a nonprofitable operation); Treas. Reg. § 1.482-1(a)(2) (trade or business is "any trade or business activity of any kind"); cf. IRC § 513 (separate activity is trade of business even if carried on within larger aggregate of activities).

"trade" or "business" occur thousands of times in the Code and Regulations, with no uniform definition or meaning.

Even the Government admits that "Section 512(a)(3) allows a social club to deduct expenses directly connected with the production of all gross income (other than exempt function income), including expenses connected with activity that does not rise to the level of a trade or business." (G.Br. 18-19). Once having admitted this, the Government seeks to deny such deductions by requiring that they satisfy the "profit motive" test of Section 162. While this Court has held that profit motive is a key factor in determining the existence of a Section 162 trade or business (*Commissioner* v. *Groetzinger*, 480 U.S. 23, 35 (1987)), it has also admonished that analysis of the term "trade or business" must be confined to the specific Code provision and the legal and factual circumstances involved (*id.* at 27 and fns. 6-8). If a profit motive is a requirement for determining whether an activity is a trade or business, and Section 512(a)(3) deductions do not require a trade or business, then it follows that Petitioner need not have a profit motive to deduct its expenses directly connected to its unrelated business activity.

Even if Section 512(a)(3) required a profit motive test, the statutes would not yield the Government's desired approach of taxing the income, but limiting the deductions. If an activity does not have a profit motive and does not otherwise qualify as a trade or business, it must be categorized for tax purposes as something else. In the

case of an exempt social club, if the activity is not an unrelated business activity it must be categorized as an exempt activity; there are no other categories. The income of an exempt activity is not subject to tax as provided in Section 501(a) and expenses are not deductible as provided in Section 265. However in the case of an exempt social club, this type of recategorization simply cannot occur because the category of exempt activities is narrowly defined to include only income from members in payment for exempt purpose goods and services and investment income permanently set aside for charitable purposes.

The Government's reliance on cases involving the trade or business question as it applies to individuals is misplaced, as the statutory structure results in a different tax treatment. If an activity of an individual is not entered into with a bona fide profit motive and otherwise does not qualify as a trade or business, the activity is a hobby or personal activity. The income from the activity is always taxable, but if the activity is a hobby, the expense deductions are limited to the income from the activity under Section 183; if it is a personal activity the expenses are not deductible as provided by Section 262. There is no basis whatsoever to treat an exempt social club under the rules applicable to taxable individuals and ignore the statutes specifically applicable. The Sixth Circuit in *Cleveland Athletic Club* v. *United States*, 779 F.2d 1160, 1165 (1985) properly rejected the Government's position because "it would tax all the Club's unrelated business as called for by the statute, but only allow a limited portion of the deductions allowed by the statute."

B. The Government cannot read the "business" definition out of Section 512(a)(3) by claiming an inadvertent "historical use" occurred.

The Government uses (G.Br. 27) a novel "historical use" theory of statutory construction for attempting to explain away the clear terms of Section 512(a)(3),

which defines "unrelated *business*" taxable income as statutorily defined gross income less certain statutorily defined deductions. Under the Government's novel canon of construction, for which it cites no authority, the words "unrelated business" are to be given no effect because it is alleged they were unthinkingly carried over from the 1950 unrelated business tax provisions. This *ad hoc* interpretive approach violates the most basic precept that every word in a statute is required to be given effect, and general words in the statute may not be interpreted so as to nullify specific terms or phrases. *E.g.*, *Weyerhaeuser S.S. Co.* v. *United States*, 372 U.S. 597, 600-601 (1963); see *United States* v. *HCSC Laundry*, 450 U.S. 1, 5-6 (1981).

C. Petitioner's position gives full weight to the "allowed by this chapter" phrase in § 512(a)(3).

There is no merit to the Government's contention (G.Br. 29) that Petitioner's interpretation of Section 512(a)(3) reads the "allowed by this chapter" requirement out of the statute, because our test is assertedly "always satisfied" and "is no test at all." While all directly connected unrelated expenditures will always satisfy the "business" test of both Sections 512(a)(3) and 162, some will still be disallowed as deductions for failure to satisfy other Section 162 tests—for example, they will not be "ordinary," or "necessary," or will not be "paid on incurred," or substantiated. Our interpretation gives meaning to every phrase in the statute, while the Government's construction would nullify Section 512(a)(3)'s definition of certain expenses as "business" in character.[2]

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[2] The Government is similarly mistaken in attempting to interpret the "otherwise deductible" phrase in certain legislative history documents so as to nullify the extensive discussion in those same documents of the rule that all income and deductions are deemed to be business income and deductions. *See Technical Explanation of Treasury Tax Reform Proposals, Hearings on the Subject of Tax*

D. Congress' purpose was to deny deductions for exempt function losses, not for excess expenses from taxable unrelated activities.

Contrary to the Government's contention (G.Br. 25-30), Petitioner's position does not ignore or circumvent Congress' intent in enacting Section 512(a)(3). At the time of the bill, social clubs paid no income tax on either their membership income or their nonmembership income (including investment income). Congress and the Treasury were concerned that when a tax was imposed on investment income, exempt clubs would simply increase their services (and their costs) or decrease their membership revenues, and use the resulting membership loss to offset their investment income. Such a result had already happened in the case of membership organizations (including clubs) which were taxpaying corporations, and the same bill contained a provision (now Code Section 277) to prevent such offsetting of membership losses against taxable investment income. S. Rep. No. 91-552, 91st Cong., 1st Sess. 74-75 (taxable clubs); *id.* at 71-72 (exempt clubs).

In Section 512(a)(3), Congress intended to prevent the soon-to-be-taxable Section 501(c)(7) clubs from similarly offsetting membership losses against investment income. Indeed, that is the whole thrust and purpose of the language in Section 512(a)(3) dividing income and deductions into two discrete pools, the exempt function income and deduction pool, and the unrelated business income and deduction pool. Each pool is treated separately for tax purposes. Section 277 provides a similar division for fully taxable club corporations. There is no dispute that losses from the exempt function pool may not offset income from the unrelated business pool. That

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Reform Before the Comm. on Ways and Means, 91st Cong., 1st Sess., Part 14, at 5059, 5139-5140 (April 22, 1969). Accord, Department of the Treasury, *Tax Reform Studies and Proposals* (House Ways & Means Comm. & Senate Finance Comm. Jt. Pub. Feb. 5, 1969), Pt. 3, at 324.

is not occurring in this case, and that issue is a mere red herring here.

It is significant that nothing in the legislative history of either Section 512(a)(3) or 277 even suggests that Congress intended that expenses arising from unrelated business *taxable* activities could not be used to offset income from other unrelated business *taxable* activities. No published rule or regulation of any kind prevents a *taxable* club from offsetting its excess expenses on one taxable activity against income from another taxable activity, just as all taxable corporations commonly do. The Government's attempt to apply a different rule to the taxable activities of the Petitioner corporation here is unfair and unauthorized.

Indeed, for eleven years after enactment of Section 512(a)(3), the Government interpreted its Proposed Regulations[3] to require aggregation of all unrelated income and expenses in one hotchpot, and paying tax only on any resulting net income. The Government's argument that the Proposed Regulations support its current position is contrary to its admitted consistent interpretation of those Regulations from 1971 through 1981, and is repugnant to the basic premise of those Regulations that income and deductions from all taxable unrelated activities must be aggregated. See *Cleveland Athletic Club* v. *United States*, *supra*, at 1166; *North Ridge Country Club* v. *United States*, 89 T.C. 563, 579-580 (1987).[4]

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[3] Section 1.512(a)-3(b)(3).

[4] The Government's theory further contradicts the historical circumstances of the enactment of Section 512(a)(3). In 1969, the major problem contemplated when investment income was made subject to tax an attempt by social clubs to offset losses on *member* business—which have always been considerable in social clubs—against taxable investment income. In 1969, an exempt club was only allowed to engage in insubstantial *nonmember* business and still retain its exempt status—no more than 5 percent of gross receipts. Rev. Proc. 71-17, 1971-1 C.B. 683. Congress could hardly have been

II. PROFIT MOTIVE DOES NOT REQUIRE TAXABLE INCOME.

A. Petitioner's losses arose from allocations stipulated to be reasonable, and are similar to accelerated depreciation and other preferences allowed to business corporations.

The Government acknowledges (G.Br. 41-42) that many Fortune 500 corporations have continuously reported tax losses, even though they earned economic profits, and that those losses have not been disallowed on the basis that they had no profit motive. The Government rationalizes this by claiming that those losses only resulted from what it terms "preferences". But that term is merely a name for deductions which have a greater tax effect than economic effect. In the instant case, Congress and the IRS have provided social clubs a "preference" in the form of the gross-to-gross method of allocating fixed expenses, which may at times apportion expense deductions that exceed actual economic costs to the unrelated business activity. It is this Government-granted preference—stipulated to be "reasonable" here (J.A. 28)—not any effort by Petitioner to "manipulate" the deduction (G.Br. 13), which resulted in Petitioner's reporting continual losses from its unrelated business, while earning substantial economic profits.[5]

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concerned with clubs offsetting losses from such small nonmember activities against taxable investment income, and indeed the Treasury allowed such offsets continuously until 1981. Despite the Government's claims of substantial tax avoidance, the tax benefits of the deductions here were less than $5,300 for two years.

[5] While acknowledging that profit motive requires "economic profits," the Government attempts to explain away the use of that term in the many tax shelter cases as meaning "profits apart from the tax benefits generated by the shelter itself", without "disregard[ing]" fixed expenses. While the Government is correct in stating that tax benefits may not be taken into account in determining profit motive, it is wrong in suggesting that economic profit requires a tax profit rather than cash flow. The cases cited in Petitioner's Main Brief, pp. 39-42, as well as IRS' own Manual and the interpretations of these authorities by the law review authors

Far from being the sinister plot to avoid taxable income which the Government's brief attempts to portray, the use of the gross-to-gross allocation method has been authorized by the IRS since at least 1969, and has sound tax administration purposes. This method is by far the simplest method for calculating unrelated fixed expense deductions. Given the fact that there are over 50,000 tax-exempt social clubs, most of which have volunteer treasurers who have limited time, and no special expertise in accounting calculations, such a simple allocation method is a practical necessity. In fact, the actual cost allocation method, which IRS prefers, required a certified public accountant over 100 hours to prepare here. (RT 54; see J. Exs. 15-O, 16-P, 17-Q; J.A. 85.) While the gross-to-gross method sometimes yields substantial deductions —as here—this is not always the case, and that relative imprecision must be balanced against administrative practicalities.[6]

(*id.*), demonstrate that profit for profit motivation purposes means gross receipts less variable expenses—*viz.*, cash flow.

The Government erroneously relies (G.Br. 35-36) on several cases—all derived from *Hirsch* v. *Commissioner*, 315 F.2d 731, 736 (9th Cir. 1963), and *Weir* v. *Commissioner*, 109 F.2d 996, 998 (3d Cir. 1940)—to show that "profit for profit motivation purposes means "taxable income." However, as the Ninth Circuit explained in *North Ridge Country Club* v. *Commissioner*, 877 F.2d 750, 756, fn.9 (1989), *Hirsch* did not involve a situation like here where the taxpayer had net income under several economic accounting methods, but had reported a loss using a permissible tax accounting system. Indeed, in *Hirsch* the taxpayer neither expected nor received any gross income subject to tax and thus could not have a profit motive. The *North Ridge* court therefore properly treated the "taxable income" statement in *Hirsch* as inapplicable. Similarly, none of the other cases cited by the Government (G.Br. 35-36) involved situations even remotely resembling that here. Indeed, in *Weir* the taxpayer purchased stock in a corporation which owned his residence for $25,000, later sold the stock for $3703, yet the court still found a profit motive.

[6] The Government repeatedly contends that Petitioner "is trying to have it both ways" by computing its taxable income using the

During the past two years the House Subcommittee on Oversight of the IRS has been considering changing the methods for making allocations of fixed expenses, but it has never suggested prohibiting use of the gross-to-gross method. Instead, it has suggested formulas which would arbitrarily disallow portions of allocated costs if the physical facility in question was not used more than 25 or 50 percent of the time for unrelated activities.[7] These proposals would deny any fixed allocations to Pe-

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gross-to-gross method on its return, while computing profit using different methods for profit motive purposes. (See G.Br. 12, 34-35, 37, 44-46.) Yet the Government itself has successfully argued for use of different accounting methods for different tax purposes in a social club exemption case. In *Pittsburg Press Club* v. *United States*, 536 F.2d 572 (3d Cir. 1976), after remand, 579 F.2d 751 (1978), after second remand, 615 F.2d 600 (1980), the court adopted the Government's position that the taxpayer club engaged in business for purposes of denying Section 501(c)(7) exemption on the basis of profit consisting of gross income over variable expenses. This was so even though the club had tax losses in several years as a result of deducting variable and fixed costs.

Here, the Government's Proposed Regulations required deduction of allocated fixed costs, and the gross-to-gross method was stipulated to be reasonable, so Petitioner properly took such deductions like any economically profitable business which generates tax losses through accelerated depreciation, depletion, or other preferences. The unanimous Tax Court opinion in *North Ridge, supra*, at 573, properly rejected the Government's "symmetry" argument: "While there is a certain pleasing symmetry to * * * [the Government's] argument, we do not believe it determinative of the question before us. * * * We note that it is * * * [the Government which] allows the deduction of the indirect fixed costs against the nonexempt income; costs which otherwise would be borne in their entirety by the club membership. * * * The record as a whole makes it apparent that petitioner was seeking profit from these activities * * *.

[7] See Draft Report of Subcommittee on Oversight, H. Ways & Means Comm., June 24, 1988 BNA Daily Tax Report, at L-24; Summary of Main Issues in Possible Modification of Oversight Subcommittee U.B.I.T. Options, April 2, 1990 BNA Daily Tax Report.

titioner, since by law its gross income from active unrelated business may not exceed 15 percent of gross receipts under penalty of losing its tax exemption. However, any adjustment in the use of this tax "preference" should be left to Congress, and should not be arbitrarily capped by this Court using a special profit motive formula crafted by the Court for social clubs.

B. Petitioner's large and financially successful business is not a hobby or personal activity entailing special profit motivation rules.

The Government erroneously attempts to "closely analog[ize]" the activities of Petitioner with a hobby or other personal activity in order to demonstrate that the profit motive test which should apply to tax exempt clubs should be stricter than that applicable to regular business corporations. (See G.Br. 36-39.) It cites cases and statutes (*e.g.* IRC §§ 183 and 280A) dealing with individual hobbies and personal activities, and argues that the strict profit motive test assertedly applicable to those situations should be used here. We need not consider whether a stricter test exists, because those authorities involve individuals, not corporations, and are irrelevant here.

Petitioner is not an individual pursuing a hobby, but is rather an exceedingly successful business corporation, with about $1.5 million in total gross revenues per year, and over $1 million in retained earnings. (J.Exs. 4-D, 5-E.) During a 12-month period in the years in issue, its unrelated food and beverage business had a profit of over $90,000 using the per-person method for allocating fixed expenses (J.A. 81.); it had net income of about $20,000 per year using the "actual use" method of allocating fixed expenses preferred by IRS. (J.A. 29) Petitioner is a business corporation which is taxed as a corporation under Code Section 11 on all its income, save specified exempt function income. It is farfetched and erroneous for the Government to contend (G.Br. 36-39)

that Petitioner should be governed by tax rules designed to apply to individuals who attempt to offset losses on personal vacation homes, or yachts, or a speculative gambling venture, or a horse petting farm, against taxable individual income. Indeed, the only other authorities cited (G.Br. 37) are Code Sections 183 and 280A, which by their specific terms do not apply to corporations.

In reality, the ordinary profit motivation rules, applied by the Tax Court in situations involving economic entities such as corporations and partnerships, should govern this case. In the case of corporations, there is very little authority on profit motivation, because corporations are presumed to have a profit motive.[8] The Government has cited no authority whatsoever for its proposition (G.Br. 30-31) that a corporation may deduct excess expenses arising from one of its loss activities against income from another profitable activity only if the loss activity has a nexus to the profitable activity. The fact is that a corporation may have New York City real estate generating continuous tax losses in the same corporate structure with its profitable Las Vegas gam-

[8] That ordinary business corporations are not denied deductions on the basis that an activity does not have a profit motive is shown by the absence of any trade or business test in Section 165, which provides deductions for corporate losses, although Section 165(c)(1) imposes a trade or business requirement for individuals. The requirement was omitted because "trade * * * or business does not require proof in the case of corporate taxpayers * * * [since] it is presumed that any transaction entered into by a corporation is either for profit or in connection with a trade or business. Parker, *Deductions and Credits*, 76-77 (1967 ed.) (footnotes omitted); accord, B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders*, par. 5.03 (5th ed.); S. Surrey and W. Warren, *Cases on Federal Income Taxation* 338 (1960 ed.). Only where a corporation engages in an activity which is primarily for the personal benefit of its officers or shareholders will expenses from the activity be disallowed. B. Bittker and J. Eustice, *supra* (citing cases). The expenses here were stipulated to be those required to provide services to nonmember customers in order to generate economic profits, and were not personal expenditures of the members.

bling casinos, and net out the losses and profits on its annual form 1120 corporate income tax return.[9] All Petitioner seeks is similar tax treatment for the deductions in its taxable unrelated business pool.

CONCLUSION

For the reasons stated, the judgment of the Ninth Circuit should be reversed.

Respectfully submitted,

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[9] Taxable corporations commonly acquire "loss" corporations for precisely that purpose: in that limited acquisition situation, there are certain rules restricting the acquiring corporation's use of the losses of the acquired corporation. See Code Sections 269 and 382. Indeed, the Code even allows consolidation of income and losses among affiliated corporations. See Sections 1501-1505.